DOCTORAL THESIS

Choice of Law in State Contracts in Economic Development Sector: is there Party Autonomy

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CHOICE OF LAW IN STATE CONTRACTS IN ECONOMIC DEVELOPMENT SECTOR - *IS THERE PARTY AUTONOMY?*

by

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C E R T I F I C A T I O N

This thesis is submitted to Bond University in fulfillment of the requirement for the Degree of Doctor of Legal Science.

This thesis represents my own work and contains no material which has been previously submitted for a degree or diploma at Bond University or any other institution, except where due acknowledgement is made.

Signature.....

Date.....

A C K N O W L E D G M E N T S

The writing of this thesis has been the most unforgettable experience of my life. I have lived in a foreign country over the last five years. At the same time, I was learning English too. As with all such endeavours, it would not have been completed without the support of many other people who have generously helped me.

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THESIS ABSTRACT

Choice of Law in State Contracts in Economic Development Sector:

Is there Party Autonomy?

A state contract is a common mode of entry for foreign direct investment, especially in developing states. It can form the legal basis of the investment relationship between a foreign investor and a host government. But, like any other contract, it cannot stand itself covering all aspects of the legal relationship. The contract thus must belong to a specific legal system or a body of rules or principles which is usually called "applicable law "or "governing law".

Historically, a "concession contract" in the natural resources sector was the predominant form of a state contract and it used to be governed by the domestic law of each host state. However, since the 1950s, international investment arbitrations have abandoned the tradition and advanced a theory subjecting state contracts in the foreign investment sector to an external legal system, ie public international law. One of the bases of the theory of internationalisation was the principle of party autonomy that allows parties to a state contract to select any law of whatever country they like. Then, the 1965 Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States (*ICSID Convention*)[1] formally adopted the principle of party autonomy in Article 42 (1) as the primary choice of law rule in disputes arising out a foreign investment contract concluded between a state and a national of another state.

The object of this thesis is to prove that the fundamental problems of party autonomy in foreign investment contracts involving considerations of public and private law issues remain unsettled. It explores the main controversies and confusions in the theory of internationalising

[1] *Convention on the Settlement of Investment Disputes between States and Nationals of Other States,* opened for signature 18 March 1965, 575 UNTS 159 (entered into force 14 October 1966) [hereinafter *ICSID Convention*].

state contracts, looking at its historical context. It examines the extent of the application of party autonomy in state contracts such as natural resource exploitation contracts and construction of a plant and infrastructure contracts which reflect important economic development policies of developing countries.

In considering past and current problems in the field of international investment law, the thesis argues that arbitral tribunals resolving disputes between a state and a foreign private individual should abandon the party autonomy approach because contractual freedom to choose the law of the contract would disregard the objectives which host states normally pursue through economic regulations such as development, environment and human rights concerns of foreign investment. It suggests a consensus-based approach similar to the rule adopted in the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities (*Hague Securities Convention*)[2] and which would produce the desired effect. It recommends that the choice of law provisions found in Article 42 of *ICSID Convention* would need to be either modified or repealed. In doing so, this thesis attempts to contribute to the positive development of international investment law balancing state authority and private property rights.

[2] *Hague Convention on the Law Applicable to Certain Rights in Respect of Securities,* opened for signature 5 July 2006, available at <http://hcch.e-vision.nl/index_en.php?act=conventions.text&cid=72 > at 23 December 2007.

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A B B R E V I A T I O N S

BIT	Bilateral Investment Treaty
ECT	Energy Charter Treaty
GA	General Assembly
GATT	General Agreement on Tariffs and Trade
ICC	International Chamber of Commerce
ICJ	International Court of Justice
IIT	International Investment Treaty
IMF	International Monetary Fund
ICSID	Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States 1965
NAFTA	North American Free Trade Agreement
New York Convention	New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petroleum-Exporting Countries
TNC	Transnational Corporation
TRIMs	Agreement on Trade-Related Investment Measures
UK	United Kingdom
UN	Organisation of United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNIDROIT	International Institute for the Unification of Private Law
US	United States of America
WTO	World Trade Organisation

Part One: INTRODUCTION

> *"The choice-of-law rule is an odd creature among laws. It never tells what the result will be, but only where to look to find the result; and the author of the rule cannot foresee the outcome. Such rules are made by theorists in an effort to impose an external order upon the states; they do not come naturally from legislatures, which are interested in foreseeable results."*
>
> *Brainerd Currie*[1]

A. BASIC SCENARIO

Like many other fields of law, the whole investment issue had been an entirely national issue until after the Second World War. It was only after the dissolution of colonialism that the need for an international system of investment protection became a major concern of capital exporters. The reasons for this need must be explained by discussing the changes in world politics following the World War Two.

The most important change was the liberal movements towards political independence sweeping Asia and Africa in the 1950's. Dozens of European colonies in the continents got not only independence, but also complete control over their own economies. The governments in these states began to play central and pivotal role in their national economies intervening and engaging in the economic affairs of the countries. Such interventions were intended to build a strong national economy and provide social services such as banking and insurance, communications and transportation for public.

The widespread involvement of the state in economic life greatly affected old concession contracts signed between foreign investors and former dependent governments. In some cases the host state's interference led to expropriation of properties of foreign investors.[2] The key sectors of the economies such as land, natural resources and other wealth mainly owned by nationals of the colonial empires were transferred to state ownership. At the same time, such

[1] Brainerd Currie, *Selected Essays in the Conflict of Laws* (1963) 170.

[2] On the role of economic nationalism in the international society, see James Mayall, *Nationalism and International Society* (1994) 70-110.

interference with contractual commitments seemed legitimate. Under the traditional view, transactions between a sovereign state and a subject of another state are governed by the domestic law of each host state. In other words, the conditions for the validity of concession contract, the capacity of the parties, the process of formation of the contract and as well as the operation and termination of the contract were a matter of the host state's domestic law.

On the other hand, international law could not provide much protection for foreign investors from the interference of newly-emerging states with their contractual arrangements. In the old colonial system, the imperial powers and imperial system gave sufficient protection for investments flowing from the imperial states, if not by legal means such as diplomatic protection, by the use of force. Such a system of protection was ended with colonialism itself.[3]

Besides, the Third World states freed from colonialism had been concerned with the unequal nature of international legal order. They started to compel the dominant states to listen to their voice. Most of all, the states justified the nationalisation policies of newly independent states, claiming that it is lawful to restore and return the properties earned by foreign individuals through illegal means to the people of the territory.[4] So in most cases no compensation was given to the foreign investors.

Accordingly, foreign companies operating in the newly independent states were put at risk of losing their property. The companies rejected the changes to the contracts and demanded that the disputes regarding the change be settled by international arbitration not by domestic

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[3] Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (2nd ed, 2004) 22-23.

[4] Eg, Hannan wrote:

> "It is not the obligation of the Islamic government to protect properties that has been earned through illegal means rather Islamic government will confiscate properties earned through illegal means as all illegal means are forbidden. All illegal means are forbidden (haram) and undesirable (munker) in Islam and elimination of haram and munker is the principal responsibility of the Islamic government. There are many instances in the Islamic history of confiscating wealth earned through illegal means and restoring and returning them to their original owners." Abdul Hannan, 'The Role of the Government in an Islamic Economy' (Series, Islamic Economics Research Bureau, Bangladesh, 2002).

courts of the host state. Therefore, a new type of international arbitration of state contracts emerged to provide protection for foreign investors.

The strategy of protecting investment through international arbitration starts with the insulation of foreign investment contracts from the orbit of the law of the host state. The traditional position relating to applicable law in disputes between private persons and foreign governments needed to be abandoned. Instead, since mid 20th century, international arbitrations between a state and a foreign investor have begun to push the idea that a supranational system applies to concession contracts. A later extension of this thesis was that disputes arising from foreign investment agreements must be settled in accordance with public international law.

Being inconsistent with prevailing juristic theories, the theory of internationalisation has caused serious doctrinal debate among legal scholars. It has posed many serious theoretical controversies that relate to both public and private international law. Much confusion arose because of efforts of the arbitral tribunals to regulate the state/citizen contractual relationship by public international law as if state contracts were akin to treaties between two sovereigns.

One of the vehicles used for internationalisation of applicable law was the principle of party autonomy. It was claimed that, in pursuance of party autonomy, the parties can choose public international law as the law applicable to the contract. The *Convention on the Settlement of Investment Disputes between States and Nationals of Other States*[5] adopted by the World Bank in 1965 granted direct legal force to the claim by expressly stating in Article 42 (1) that *"The tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties."* However, a controversy remains on the possible application of party autonomy to state contracts in economic development sector despite this legal recognition.

[5] *Convention on the Settlement of Investment Disputes between States and Nationals of Other States,* opened for signature 18 March 1965, 575 UNTS 159 (entered into force 14 October 1966) [hereinafter *ICSID Convention*].

B. RESEARCH PROBLEM AND RESEARCH QUESTIONS

The problem addressed in this research is:

- *Is the party autonomy rule, which naturally deals with purely private law conflicts, also capable of being applied to disputes between a state and a national of another state and what is the outcome of applying party autonomy to disputes involving the public interest?*
- *How far may a government party to an economic development agreement choose the law of other country which has no relevance to its economic and developmental policies?*

Although it has been almost a half century, since the text of Article 42(1) of the *ICSID Convention* gives prominence to the principle of party autonomy, one still wonders how party autonomy intended to advance rights and liberty of individuals can work in an area of regulatory concern which involves a controversial task of balancing private objectives of foreign investors to pursue more profit against public objectives of a host state to improve the welfare of its population. The basic problem in this respect is the outcome produced by the application of party autonomy. Party autonomy allows parties to a contract the power to settle their contractual disputes by their own dispute settlement body and under their own selected set of rules. Therefore, national economic policies or social objectives embodied in regulatory laws could be undermined and abandoned.

On the other hand, it is not very conceivable that a host state selects a system of law other than its own as the law governing its contract concluded with a foreign private party. Foreign investment contracts play an important role in the economic development process of developing countries. As a result, host states usually subject such contracts to special rules which reflect their development policies. Without the application of such rules significant opportunities for the economic development of host states would be lost. In this regard, it seems that a host

state better chooses its own law rather than the law of other country whose laws have nothing to do with its national economic interests and social objectives.

To explore this research problem, the following research questions are identified:

- *What are the inherent nature and characteristics of a state contract that make them incompatible with the notion of party autonomy?*
- *How was accepted the principle of party autonomy in disputes between a state and a national of another state? What is the theory of internationalisation of state contracts?*
- *What are sources of international law on foreign investment and what is their relation to the principle of party autonomy?*
- *How does the principle of party autonomy work in purely private relationships? What are attitudes of domestic and international legal systems in relation to the principle?*
- *How has the principle been applied in the context of ICSID tribunals?*
- *What barriers there are in applying the party autonomy principle in economic development agreements?*

The research questions emerged from preliminary research and were subsequently used to establish the focus through which the research problem was considered. Only after the process of questioning, expanding, exploring and excluding all these questions has been completed, it will be possible to find solutions to the research problem of the thesis "*how does party autonomy work in state contracts and does a state party to the contract in reality choose the law of a country other than its own?*".

C. JUSTIFICATION FOR THE RESEARCH

The question of the law applicable to an international contract of investment has been extensively studied since the elaboration of the theory of internationalisation introduced choice of law rules in this field. However, the available literature mostly analyses problems of the theory

of internationalisation such as the theoretical incapability of international law to regulate contractual arrangements and the scope of law applicable by parties' choice, but not the assertion of party autonomy in state contracts. Some comments have been made with the regard to the nature of state contracts that make the extension of the party autonomy principle to foreign investment contracts with a state party unwise, but the question raised in this thesis has not been specifically addressed in prior studies.

Meantime, it is true that the area of foreign investment is reflective of a North-South political scene. Much of the previous literature on the choice of law issue in state contracts is written by scholars from developed states who do not know about developing countries' legal systems and their needs and aspirations. This causes starkly unbalanced views on the nature and content of international law on foreign investment furthering developed states' goals of investment protection and liberalisation as bases of the international law on foreign investment. Hopefully, the experience of the writer with a Third World legal system on foreign investment (her own country, Mongolia) together with her training as an international lawyer makes her a suitable person to approach this topic from the viewpoint of developing states.

Another justification for studying this topic is changes that have occurred within international investment law since the adoption of the ICSID Convention. The growing social, environment and human rights concerns of foreign investment is one of the most significant developments in international investment law. In light of these concerns, the protection and promotion of foreign investment is no longer the sole objective of today's international investment law. Reflecting the new trend, now it is common to refer to foreign investment contracts as economic development agreements (hereinafter EDAs). Such contracts are meant to improve economic conditions of people of a host state and increase their standard of living.

From this development-oriented perspective, regulatory interventions are necessary for achieving the special developmental goals. In this sense, research in this area, therefore, is urgently needed to investigate whether the principle of party autonomy is capable of meeting the realities of international economic development law. Party autonomy empowers private firms investing in developing states to operate free from direct intervention of national legal systems. If they choose a different country's law as the law governing their activities, important policy objectives of host states would lose their significance.

This research paper is written for a broad audience: practising lawyers, legal and social academics, and governmental officials of developing states dealing with contracts between a state and a foreign investor as well as financers and investors who want to invest in developing countries. The paper will allow them to understand better the general picture of contemporary international law on foreign investment and its developmental strategies. It will raise awareness and discussion among scholars on the importance of modifying the choice of law method. More importantly, the research may have significance for policy makers of developing states. It should be noted that insufficient understanding of the policy makers on the course of the law may lead to the adoption of unfair or inefficient legal regimes relating to foreign investment sector.

The most important aim of this research is to examine the suitability of traditional choice of laws techniques for resolution of disputes of regulatory nature, particularly in the case of foreign investment disputes. The thesis reveals that the principle of party autonomy has never worked in the field of foreign investment contracts in the way it is supposed to work. The potential significance of this research lies in the possibility of replacing the party autonomy approach with a new approach which is capable of striking a balance between private rights of foreign investors and sovereign rights of a host state.

D. THE STRUCTURE AND SCOPE OF THE THESIS

The material in this thesis is structured as follows.

- Part II begins with discussions on the theory of public law contract which is recognised in several domestic legal systems though the precise approach varies from system to system. It also discusses the nature and characteristics of modern types of foreign investment contracts in order to show that these contracts began to be considered as public law contracts.
- Part III examines the theory of internationalisation of state contracts, which first introduced choice of law techniques to the field of former concession contracts. The consideration of the theory is very important for understanding issues surrounding the applicable law of an investment contract between a state and a foreign private party.
- Part IV reviews the scope and content of international investment law by presenting the origins, problems, and political and legal positions of North and South bloc States in the development of this law. It outlines the subject matter of emerging law on economic development.
- Part V is the core part of this thesis. It investigates major obstacles in applying the principle of party autonomy that is used extensively in the field of international commerce to the investment environment. It assesses all theories and concepts that may confront the application of the principle in foreign investment contracts.
- Part VI summarises the results and the interpretation of the analysis discussed in previous parts of the research to make an overall conclusion. Then it proposes directions for future work.

It is beyond the scope of this thesis to consider all contracts made with a state or state agency with a foreign private party. Only those contracts which qualify as foreign investment contracts have been investigated in detail. For the purpose of this thesis, a foreign investment contract is defined as an agreement concluded between a state or state agency in sovereign capacity on the one hand, and a foreign corporation or individual on the other hand for execution of a public development project which involves certain risks and lasts over a long period of time. This definition is consistent with the approach accepted in the ICSID arbitration. Although each contracting party may anticipate its own gain, in order to confer special privileges upon either of parties, the investor/ state arbitral tribunal must consider whether the contract concerned makes significant contribution to the host state's economic development. In this

regard, contracts in the petroleum and natural resources sector and large infrastructure projects such as contraction of roads and ports come within the definition of foreign investment contracts. Traditionally, these sectors have played a dominant role in the development of national economy.

Other types of state contracts such as procurement contracts or sales contracts between states and foreign private parties may have relevance to the discussion of state contracts. But such contracts have a quite different nature and do not have the features that may result in distinguishing them from ordinary contracts. The significant difference between international investment and international sales agreements is that the foreign investment type contract brings fresh capital into the host country whereas the procurement contract or sales agreement does not create such assets of value in that country. Being more commercial in the nature, international sales and procurement contracts are excluded from the scope of the thesis. Such contracts are also not considered to be investment contracts under international investment agreements.

This paper is entirely focused on the choice of law issues of investment contracts made by host governments with foreign investors and does not set out to consider other problems of private international law that emerge in this particular field. The content of private international law generally deals with a function of national rules on three major topics: jurisdiction, choice of law and recognition of judgments. The jurisdiction and recognition issues for investment proceedings are less controversial than choice of law issue because of the successful acceptance of the ICSID arbitration and the *New York Convention on Enforcement of Foreign Arbitral Awards*.[6] The law is stated as at 1 January 2008.

[6] *Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, opened for signature 10 June 1958, 330 UNTS 38 (entered into force 7 June 1959) [hereinafter *New York Convention*].

Part Two: UNDERSTANDING THE NATURE AND CHARACTERISTICS OF STATE CONTRACTS

The concept of state contracts is a fairly complicated issue facing legislators in any country. The reason for this complexity is its specificity, which keeps it from being ascribed to a particular type of the traditional civil law contract. No one denies the fact that this type of contract has the civil law character of the underlying relationships. At the same time it bears certain elements of public law (or administrative law) relationship.

On the other hand, the confusion as to the legal nature of state contracts is even more troubled when it comes to the field of international law, for at least two reasons. First, because the theory of internationalisation of state contracts was intended to provide protection to foreign investors this has undermined the fact that these contracts are not always treated in the same manner as civil contracts at domestic level. Instead of taking into consideration the relevant rules of municipal legal systems in relation to public law contracts, the earlier international arbitration of investment disputes applied purely commercial law principles in solving conflicts arising from the contracts.

Additionally, the issue has been politicised since the breakdown of colonialism. In fact, private oil companies do not operate independently of their home government. In establishing a profitable global investment environment, the home governments' influence, priorities and foreign policy are highly relevant.[1] Thus, industrialised countries, mainly through international

[1] The developed world position towards the regulation of foreign investment is clearly expressed, for example in the speech of David Andrews, the Legal Advisor to the United States. As he stated at the annual meeting of the Institute of World Business Law, since "… the US is responsible for 1 trillion dollars of investment abroad, and with such huge investments, the effective protection of investment is crucial to economic security". Further he noted that in addition to usual concerns of market-oriented policies, investment protection measures, international legal standards, and export provisions, protection of intellectual property rights is a great concern for assessment of risk in investing in developing countries. See Institute of World Business Law, *Investment Protection* (20th Anniversary Annual Meeting, 2000) <http://www.iccwbo.org/home/business_law/conference_reports/investment.asp> at 6 January 2005.

financial institutions, have been pursuing investment liberalisation to eliminate the regulatory barriers to investment of their own firms entering into the developing host states.

On the contrary, developing states, strengthening the traditional administrative approach of municipal law, have asserted a doctrine of permanent sovereignty over natural resources to seek to localise control of the investment in the host state and to subject it to the host state's law.[2] They see the public law approach as a way to implement their social and economic policies restraining the operations of established foreign companies that do not meet their policy standards.

In focusing on legal considerations related to the concept, Part II attempts to identify the legal nature of state contracts. *Chapter One* discusses the evolution of the theory of public law contract, assessing specific approaches of municipal legal systems concerning state contracts in a comparative perspective. In the second part of *Chapter One,* various techniques used to distinguish state contracts from ordinary commercial contracts are examined.

Chapter Two of this part examines the important features of state contracts in the foreign investment sector, including their status in international law, the most common types of state contracts in this sector. It also argues that the evolution of new principles of international law has influenced the characterization of foreign investment contracts from the angle of economic development. As a result, foreign investment contracts are no longer contracts which are subject to ordinary rules of contract law.

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[2] Waelde and Ndi noted that:

> "In the current mood of scramble for foreign investment covering not only the Third World, but also the ex- (and the few still-) socialist countries, private and foreign investment is experiencing a strong and positive re-appraisal over the state- and national-dominated model of investment of the past." See Thomas Waelde and George Ndi, 'Stabilising International Investment Commitments: International Law versus Contract Interpretation' (1996) 31 *Texas International Law Journal* 215, 217.

CHAPTER ONE: THE THEORY OF PUBLIC LAW CONTRACT

1.1. The Evolution of the Concept of Public Law Contract

With the development of the welfare state that began in Europe in the late 19th century, the activities of government that were previously limited to the maintenance of law and order extended to a wide field for non-coercive activities such as social insurance, health, education, housing and transportation. To discharge these functions the government organs and departments needed to deal with private commercial and industrial organisations, as well as with state-owned corporations by concluding contracts with them.[3] The concept of public law contract thus was introduced to the domain of contract law.

In order to show important features of state contracts, the reasons for distinguishing state contracts from other types of contracts as well as the conceptual differences between civil law and common law systems in relation to public contracts must be examined.

1.1.1. THE JUSTIFICATIONS FOR THE CONCEPT OF PUBLIC LAW CONTRACT

The involvement of public authority in the contract for the execution of public service was a sufficient factor to give birth to a new specific category of contract that has a mixed nature. Being commercial, its commercial nature requires that disputes arising from it must be settled in accordance of general rules emphasizing the merits of market economy and liberalism. On the other hand, being of a public nature, its public character justifies intervention of a public body in the realisation of the contract and thereby undermines the rules and conditions of commercial law. The existence of these mixed interests that are ingrained in a state contract has raised the issue of reconciling public interests and individual rights in this area of economic activity.

[3] For example, in 1904 the City of Bordeaux granted a company a concession for the provision of gas and electricity within the city limits for a period of thirty years. See *Compagnie générale d'éclairage de Bordeaux*, Conseil d'Etat, Decision of 30 March 1916.

The reasoning behind the need to treat such public law contracts differently from ordinary commercial contracts is the assumption that the main motive of a state party entering into public law contract is the benefit of its people. The state party acts in the public interest. Its value lies in serving the special needs of the public as a whole community. The profit made from the contract will be used for the public good. In an early statement of the French law it was stated that:

> "In every contract involving the performance of some public service, the state does not contract as an ordinary individual. It is not concerned to protect the interests of individuals. It contracts on behalf of the society, for the necessities of the public service, for the common general interest. Every time, it enters into a public contract, it does something more than does a contractor under the Civil Code or the Commercial Code. Because it goes beyond this, one should not apply to it the same rules as one does to an ordinary private law contract. This is logical and this is also the law." [4]

Another underlying justification for the privileges of the state party in contracts is the legal tradition which divides law into public and private.[5] When a contract is made between a state or its agency and a citizen, one needs to distinguish public law elements from private law elements. The boundary between the two could serve as a decisive factor in determining the degree of government control on the contractual relationship. The legal doctrine itself has Roman roots dating back to at least two centuries BC, and has been prominent ever since in the continental European countries whose legal system grew from it. The great Roman jurists, under

[4] Conclusions of M Corneille, Comm Du Gouv (1918) R. 246 cited in A W Mewett, 'The Theory of Government Contracts' (1959) 5 *McGill Law Journal* 222, 226.

[5] For a comparable use of the distinction in contemporary constitutional analysis, see e.g., Henry Friendly, 'The Public-Private Penumbra-Fourteen Years Later' (1982) 130 *University of Pennsylvania Law Review* 1289 (discussing the distinction between state action and private action). Some have recently attempted to connect the public-private distinction with liberal political thought. See, eg, Duncan Kennedy, 'The Stages of Decline of the Public/Private Distinction' (1982) 130 *University of Pennsylvania Law Review* 1349.

the influence of Greek philosophy that juxtaposed the state and the individual, divided all law into public law *(jus publicum)* and private law *(jus privatum).*[6]

The separation of public and private law is a foundation for legal systems of civil law countries particularly France, Germany and Italy. In the view of civil lawyers, private law, as a rule, deals with the relationship and the resolution of conflicts among individuals. The private law areas thus include contracts, torts, property, corporations, agency and partnership, trusts and estates, and remedies -- subjects defining the enforceable duties that all individuals owe to one another. Public law, by contrast, focuses on the relationship and the resolution of conflicts between individuals and the state, with governmental regulation of individual and corporate activities and, with power and its limitations. Public law branches include constitutional law, taxation, administrative law, criminal and civil procedure, and at least that part of criminal law which regulate the relationship between governmental agencies and between governmental agencies and private parties.

However, the distinctions of law are not always clear in practice. The emergence of a variety of social and economic regulation, and the increasing role of government in legal areas previously left to market forces, have resulted in a practical complexity of drawing a clear line between public law and private law. Therefore, to distinguish public law from private law, a variety of theories have been used and the most common ones are "interest theory" and 'subject theory". Under the interest theory, the classification is made according to the subject matter governed and the nature of the rules applied by law. In drawing a line between the two branches of the law, the Romans focused their attention on the character of interests protected by the law. As Ulpian, a Roman jurist defined, "public law is that branch of the law which focuses on the

[6] As Dean Pound explained of Roman law, "private law had to do with adjusting the relations… and determining the controversies between man and man, while public law had to do with the frame of government, the functions of public officials, and adjustment of relations between individuals and the states". Roscoe Pound, 'Public Law and Private Law' (1939) 39 *Cornell Law Quarterly* 469.

status of the Roman state, ie, the interests of the community, while private law considers the interests of individuals".[7]

Nowadays, it is difficult to identify which interests are public and which ones are not. The regulation of relations between private individuals and the peaceful resolution of conflicts are in the interest of the state and the community, as well as of the private individuals involved. Public law may place limits on private law to effectuate the public interest. Consumer protection and minimum wage laws are examples of this kind of limitations.

As a result of the overlaps between public and private interests, the traditional "interest-theory" of the Roman jurists has been abandoned and replaced by other theories amongst which the so-called "subject theory" appears to be gaining favour. According to this theory, the criterion of division between public and private law is not the character of the interest protected by the law, but rather the character of the parties involved in a given legal relation. If state acts in its sovereign capacity and performs the proper functions of its sovereign power, then the action or relation is of a public nature and governed by the rules of public law. If a state engages in actions or relations as a private party without appearing in its sovereign capacity, then the relation is private and governed by the relevant rules of private law.[8]

The concept of the state acting in two capacities further has developed into the distinction between acts of public power, over which there is no domestic jurisdiction and acts of private power which are subject to the ordinary courts in the same way as acts of private individuals.[9] Although it is generally accepted that a sovereign state may perform "public" and

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[7] *The Digest of Justinian (*revised English-language ed, 1998) 1.1.1.2.

[8] Nigel Foster, *Austrian Legal System and Laws* (2003) *xix*.

[9] Hazel Fox, *The Law of State Immunity* (2002) 275.

"private" acts, the way the distinction applied varies from jurisdiction to jurisdiction. The question will be discussed later.[10]

The classical division of law into public and private also has influenced common law jurisdictions. However, a common law perspective in the sphere of public law has its own features.[11] In common law jurisdictions, the term public law basically refers to constitutional and administrative law and it is relevant solely to the type of remedies afforded when one of the parties is a public entity.[12] The development of distinct administrative law in these countries has led to the recognition of analogous distinction between public and private acts of a sovereign state.[13]

Before the methods and techniques of distinguishing public and private acts of a state are discussed, one should conduct a comparative analysis of state contracts in two major legal systems. Court cases or other legal principles of handling the problem of government contracting are also cited. The purpose of this exercise is to show that everywhere a distinction between public and private contracts is recognised.

1.1.2. COMPARATIVE LAW ON PUBLIC LAW CONTRACTS

(i) State Contracts in Civil law Countries

The theory that recognises the specificity of government contracts is dealt with more comprehensively in French law, thus it is known universally under the French name of *contrats administratif*. French jurisprudence has long recognised the separate treatment of administrative

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[10] See Ch 2, Subsection 2.1.1 (The Methods of Determining Public Law Contract).

[11] One of the basic principles of public law in common law countries is the historical theory that the reigning monarch was the source of all government power irrespective of whether the power was legislative, executive or judicial and he as well as his servants acting on behalf of him thus had legal immunities and privileges which collectively became known as "the shield of the Crown". See C M Doogan, *Commonwealth Administrative Law* (1984) 56.

[12] Peter Stein, *Legal Institutions: the Development of Disputes Settlement* (1984) 107.

[13] See further discussions on this distinction in Ch 2, Subsection 2.1.1 (The Methods of Determining Public Law Contract), (ii) State Contracts in Common Law Countries.

contracts and has developed an independent set of rules to deal with administrative contracts. The great French jurist Rene David defines this as follows:

> "The general interest of the public welfare is that it induces this attitude of the *tribunaux administratifs*, which decide cases according to "reason" adjudicated cases at the dawn of the common law. The interpretation and effects of contracts in which a public body is involved, are not governed in France by the rules of droit civil, but are held to be a matter of *droit administratif*, where special circumstances ought to be taken into consideration."[14]

In France, therefore disputes arising in connection to administrative contracts fall within the jurisdiction of specialized courts, ie the *tribunaux administratifs*. Accordingly, French law prohibits arbitration agreements in administrative contracts. This general rule was recognised as early as 1806 in the original French *Code of Civil Procedure*.[15] In 1972 the French *Civil Code* restated the principle.[16]

This principle of prohibition was later lessened as a new law was enacted allowing certain public entities of industrial or commercial character to enter into arbitration agreements.[17]Also, in the mid 1960s, France ratified two major international arbitration Conventions, namely the 1961 *Geneva Convention on International Commercial Arbitration* authorising public entities to conclude valid arbitration agreements and the 1965 *Washington Convention on Investment Disputes* creating arbitration mechanism between states and foreign private parties.

Despite the government's willingness to encourage arbitration of disputes involving state entities, French administrative judges traditionally have been very reluctant to allow arbitration in a contract defined as an administrative contract. In 1986, when the *Conseil d'Etat* (the Supreme

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[14] Rene David, 'Frustration of Contract in French Law' (1946) 28 *Journal of Comparative Legislation* 11, 13-14.

[15] Art 1006 prohibited arbitration of disputes where a notification to the Attorney General's office was required. Art 83 listed among such disputes those concerning "public policy, the State, State property, the cities and the public bodies."

[16] Art 2060 provides: "One may not enter into arbitration agreements in matters of (. . .) controversies concerning public bodies and entities and more generally in all matters in which public policy is concerned."

[17] *Law of 9 July 1975.*

Administrative Court) was asked by the government to provide an opinion in connection with a contract between French administrative bodies and the Walt Disney Company concerning the Euro Disney project, the court concluded that the contract should be governed by French domestic public policy rules, and "not governed by principles applicable to international commerce."[18]

Nevertheless, recently the French government reaffirmed its favour for arbitration by issuing an act (the *"2004-559 Act"*) authorizing parties to a partnership contract to submit their disputes to arbitration. Indeed, that was a significant departure from the traditional principle prohibiting arbitration clauses in public law contracts. But this time the *Conseil d'Etat* did not oppose the provision of the governmental act, rather the court held the act as valid.[19]

Therefore, it seems that in France the principle of non-arbitrability of public contract disputes has been replaced by a policy favouring arbitration. However, when it comes to the applicable law of public contracts, the government is hesitant in subjecting French administrative contracts to a foreign law. When the government authorized by the *2004-559 Act* the arbitration of administrative contracts, it required the mandatory application of French law.[20] The general principle of French law is that administrative contracts are governed by administrative law.

Maintaining a dual contractual approach, French law has developed sets of special rules and principles which only apply to administrative contracts. These rules and principles are purported to maintain a rational balance of interests of parties in such an unequal relationship. One of the principles is *theorie de l'Imprévision* (the theory of the lack of foresight), according to

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[18] Opinion dated 6 March 1986, *Conseil d'Etat*, Ass. Rev Arb (1992) 397.

[19] About the position of the *Conseil d'Etat* in relation to the 2004-559 Act, see Pierre Heitzmann, 'The Contrat de Partenariat: A New Form of French Public Private Partnership Allowing the Use of Arbitration to Adjudicate Disputes' (2005) 23 *The International Construction Law Review* 1.

[20] The *2004-559 Act* provides that parties to a Partnership Contract may "submit disputes to arbitration, with the application of French law." The Act defines Partnership Contracts as administrative contracts. See Art 1.

which the rights and obligations of parties can be revised in the event of unforeseeable external events upsetting balance of the contract.

The principle is well illustrated in the *Gaz de Bordeaux* case[21], where the French *Conseil d'Etat* heard a dispute brought by a private company against the City of Bordeaux. In that case the city had granted the company a concession to provide gas lighting to the city. The concession contract had a fixed price, but because of the First World War, the price of coal used by Gaz de Bordeaux more than tripled causing the company extreme financial loss. The *Conseil d'Etat* ruled that the company was entitled to compensation for the increased costs of the raw materials from the administration.

The theory imposes to the contracting public person the obligation to help the holder of the market financially to carry out the contract, when an unforeseeable and foreign event caused the upheaval of the economy of the contract. Accordingly, the contractor has a right which his civil law counterpart cannot have.[22] On the other hand, the concept of *imprévision* can be also revoked by the government party. If the performance of such a contract contradicts with the public interest, the theory also enables a state contractor to escape from its contractual obligations.[23]

In France, the doctrine of *imprévision* applies in limited circumstances particularly, in contracts where administrative law would apply. In private law contracts the parties may only rely on *force majeure* to excuse his or her non-performance of obligation.[24] Prof Rosenn described the scope of the application of the principles as follows:

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[21] *Compagnie générale d'éclairage de Bordeaux*, Conseil d'Etat, Decision of 30 March 1916.

[22] Mewett, above n 4, 231.

[23] See Barry Nicholas, *French Law of Contract* (1982) 202; Bernard Schwartz, *French Administrative Law and the Common Law World* (1954) 158-59.

[24] *Force majeure* is part of the French civil code and thus applicable to all contracts. The main difference between *imprévision* and *force majeure* is the impossibility of performance, meaning *force majeure* is accepted only when the performance is impossible. If the event simply makes the performance of the contract more difficult or more

> "...in France, the *théorie de l'imprévision* did not develop into anything more than a method for relieving governmental contractors of unforeseeable hardships to insure the uninterrupted functioning of public services. In practice, the theory has been applied only to three contracts (1) public works, (2) governmental supplies, and (3) concessions such as gas and electricity. Attempts to expand the doctrine of *imprévision* to private contracts have been regularly frustrated by the *Cour de Cassation*, France's highest court, which has only been inclined to excuse performance of contractual obligations only if performance is literally impossible."[25]

The next principle which is very important in balancing interests of the private individual with those of the public in administrative contracts is *fait du prince* (government action principle). The principle applies when an act of the administration, either the contracting branch or a different branch, has an impact on the contract. For example, if the parties contracted according to existing law, and a new regulation increases the obligations of the contractor, then he is entitled to an indemnity.[26]

Other civil law countries such as Belgium, Italy and Germany also have accepted the concept of a distinctive public-law contract.[27]German law for example, in addition to setting administrative courts for contracts concluded with public entities, also provides very similar solutions. The *Administrative Procedure Act* allows parties to administrative contracts to renegotiate the provisions of the agreement if the circumstances which determined the content of the agreement have changed so substantially that one party to the agreement cannot reasonably be expected to adhere to the original provisions of the agreement. If such renegotiation is not

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expensive, then the obligation shall nevertheless remain due. See A H Puelinckx, *Frustration, Hardship*, *Force Majeure, Imprévision, Wegfall der Geschäftsgrundlage, Unmöglichkeit, Changed Circumstances- A Comparative Study in English, French, German and Japanese Law* (1986) 3 (2) *Journal of International Arbitration* 47, 55-56.

[25] Rosenn Keith, *Law and Inflation* (1982) 87.

[26] See *Soc Chimique*, Conseil d'Etat, Decision of 8 Nov 1957.

[27] G M Sen, 'Public Law Contract' (1973) 15 *Journal of the Indian Law Institute* 487, 490.

impossible or not reasonably expected, either of parties may initiate the termination of the agreement.[28]

The position of German law is based on the *Wegfall der Geschäfstgrundlage* (contract basis doctrine) which applies more broadly than the French *théorie de l'imprévision* generally covering all contracts including private contracts.[29] According to the German doctrine, if unforeseeable and new events which change the whole environment of the contract occur after the formation of the contract the courts may adapt or even annul the contract, if adaptation is not possible.[30] However, it has been less easily accepted with regard to commercial contracts concluded between businessmen.[31]

Many capital importing states of Asia, Africa and Latin America as well as former socialist countries have civil law traditions, meaning legal systems originally inspired by French and German law. As this tradition has evolved, the general philosophy tends to be that a contract concluded between a government authority and private party is subject to not only commercial but also administrative rules. There are many versions of the *contrats administratif* ranging from a mere prohibition of arbitration of public law disputes to the idea that unilateral termination is acceptable if original circumstances of the contract have significantly changed resulting severe imbalance in contractual equilibrium.

Notably, in Cameroonian law, the contracting authority may in the case of absolute necessity or an act of God and after the opinion of the authority in charge of public contracts, terminate a contract in the absence of any default on the part of the private contracting partner

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[28] *German Administrative Procedure Act* (1976), s 60 (1).

[29] Aziz Saliba, 'Rebus sic stantibus: A Comparative Survey' (2001) 8 (3) *Murdoch University Electronic Journal of Law* <http://www.murdoch.edu.au/elaw/issues/v8n3/saliba83.html> at 22 June 2004.

[30] Ingeborg Schwenzer, '*The Law of Contracts'* in Werner Ebke and Matthew Fink (eds), *Introduction to German Law* (1996) 177, 181.

[31] Chengwei Liu, *Changed Contract Circumstances* (2005) Pace Law School <http://www.cisg.law.pace.edu/cisg/biblio/liu5.html#cl1> at 19 February 2008.

without prejudice to damages that can be claimed by the latter.[32] Thailand has established administrative courts along with the existing judicial courts to try and adjudicate administrative cases including administrative contracts.[33] In Latin America, it is accepted that the rights of individuals or companies arising out of concessions might be affected by "a very high degree of administrative interventionism and certain restrictions".[34]

If one turns towards former socialist countries, one finds that their formal laws are imported from civil law notions. It is said, however, that they used to have a third legal system which was Marxist-Leninist law. Although communism has collapsed, one still can see reflections of the socialist legal tradition. In the communist era, there was no right of ownership to property by private persons and a state was the owner of vast resources and the basic means of production.[35]

Now in most former socialist countries the general principle is that the subsurface is owned by the state. For example, the *Mongolian Mineral Law* of 1997 states: "The mineral resources naturally occurring on and under the earth's surface and natural water courses in Mongolia are the property of the State".[36] Also, in many developing countries that have asserted

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[32] *Cameroonian Public Contracts Code* instituted by *Decree No.2004/275* of September 2004, Art 101.

[33] Under *Thai Arbitration Act* B.E. 2545 (2002) following contracts are defined as administrative:

- in which at least one of the parties is an administrative agency or a person acting on behalf of the State;
- which exhibits the characteristics of (a) a concession contract; or (b) a public service contract; or (c) a contract for the provision of public utilities; or (d) a contract for the exploitation of natural resources.

[34] Cecilia Siac, *Mining Law: Bridging the Gap between Common Law and Civil Law Systems* (1997) Centre for Petroleum and Mineral Law and Policy of the University of Dundee <http://www.saj.oas.org/lcp/Cecilia_Siac.doc > at 21 March 2005.

[35] Pashukanis, a well-known Marxist legal theorist and Soviet lawyer, wrote:

> "… private ownership of the means of production is the central concept of bourgeois civil law, public (socialist) property is the central concept of Soviet economic law. All bourgeois "civil commerce" is a particular type of the circulation of private property. Equally, the system of Soviet economic law may be correctly understood only as public (socialist) property set in motion in the struggle with private property." Evgeny Pashukanis, 'A Course of Soviet Economic Law' in Piers Beirne and Robert Sharlet (eds), *Pashukanis: Selected Writings on Marxism and Law* (1980) 321 (Translated by Peter Maggs).

[36] *Mineral Law 1997* s 5, Ownership of Minerals.

the right of sovereignty over natural resources, minerals are the property of, and are controlled by, the state on behalf of its people.[37] That position allows the state a right to intervene in order to manage or administer the resources as the owner.

It must therefore be recognised that in civil law countries, contracts such as a concession agreement covering the development of mineral resources owned by and under the sovereignty of the state can qualify as administrative contracts. In civil law, mining contracts have to conform to the codes and administrative acts; and a state has not just a right of control but a right to intervene if the public interest so requires.

(ii) State Contracts in Common Law Countries

Common law systems have not set up specific rules for state contracts, as there is no bright line separating public law from private law. In common law countries, in particular in the UK, the USA, Australia and other Commonwealth countries the general principle established by the judicial system suggests a government contract with a private entity is governed by the same principles of contract law, which govern contracts between two non-government parties.[38] For example, judicial cases of the USA assert:

> "When the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals."[39]
>
> "[When the State of Texas] becomes a party to a contract with citizens, the same law applies to it as under like conditions governs the contract of an individual."[40]

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[37] Some examples are as follows: in Argentina *Mining Code* (1887) s 7; in Bolivia *Mining Code* (1997) s 1; in Tanzania *Mining Act* (1998) s 5; in Nigeria *Minerals and Mining Decree* (Nbr. 34,1999); in Indonesia *Law Nbr. 11on the Basic Provisions of Mining* (1967) and in Philippines *Mining Act* (1995) s 2.

[38] However, there may be some limited exceptions. Particularly, the English Patents Acts provides certain exemptions for the state so that it may procure patented drugs from sources other than the patent-holder or the national health system. *United Kingdom Patent Act 1977*.

[39] *United States v Winstar Co*, 116 S Ct 2432, 2464 (1996) (quoting *Lynch v United States*, 292 US 571, 579 (1934)).

[40] *Federal Sign v Texas Southern University*, 951 SW 2d 401, 406-407 (1997) (quoting *Fristoe v Blum*, 45 SW 998, 999 (1898)).

In Australia, statutes try to make the promises made by governments as nearly a possible the same as between subject and subject.[41] *Judicial Act 1903* enabled an individual to bring a claim in tort or contract against the Commonwealth.[42] Under the *Administrative Decisions (Judicial Review) Act 1977*, any citizen can bring a claim against a government or a government decision-maker in respect of decisions that have caused him loss or damage.[43] There are no special administrative or constitutional courts for administrative decisions and, superior courts of general jurisdiction decide cases of administrative law.

In the court practice of common law countries, however, it is often acknowledged that sometimes an arrangement made with the government may have no contractual effect rather a political character. In *South Australia v Commonwealth*, the Dixon C J said:

> "The agreement now in question certainly contains provisions which no court could undertake specifically to enforce… Enough has been said to show that in the first place, to generalize about the operation of the agreement in question must be unsafe and misleading and that in the second place, it could only be in respect of some definite obligation the breach of which is unmistakably identified that a court can pronounce a judicial decree in a case such as this. It is only in this way that the necessary distinction can be maintained between, on the one hand, the exercise of the jurisdiction reposed in the Court and, on the other hand, an extension of the Court's true function into a domain that does not belong to it, namely, the consideration of undertakings and obligations depending entirely on political sanctions."[44]

Thus, in jurisprudence of the Commonwealth countries as well as American law, the theory has been put forward of the splitting up of the state functions into two categories.[45] One

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[41] David Allan and Mary Hiscock, *Law of Contract in Australia* (2nd ed, 1992) 366.

[42] *Commonwealth Judiciary Act 1903* s 56.

[43] *Administrative Decisions (Judicial Review) Act 1977,* amended by *Act No 56 of 2007*, ss 6-8.

[44] See *South Australia v Commonwealth* (1962) 108 CLR 130,141. Also see the same case for the judgment of Windeyer, 153-154. Also see *Placer Development Ltd v Commonwealth* (1969) 121 CLR 353, 367.

[45] See *Horowitz v United States,* 267 US 458 (1925); *Reynolds Metals v United States* 438 F 2d 983 (1871) where the court held: "there is a long tradition separating the contractual and sovereign capacities of the government. Its contractual duties are excused if their performance is made impossible by its sovereign acts".

is the executive function of the state that is governed by statute or statutory rules and can not be bound by any contractual commitments. The second is a contractual obligation of the state that may be agreed by the parties.[46]

If the action of the state is regarded by the courts as falling within the category of executive acts or governmental directives, the government action may override private rights including its contractual arrangements made with a private party.[47] In the US, the government is not liable for damages caused by acts performed as an integral part of its sovereign character.[48] In a substantial number of cases, the US courts also dismissed claims on governmental liability on the grounds of a doctrine, which is known as sovereign acts doctrine.[49] In the same manner the English common law dismisses the government's liability.[50] In Australian law, damages are not normally available in public law matters, unless the breach of statutory duty by officers is established.[51]

The legal basis of the rule which provides the state party to a public law contract an exit from contractual obligations is the so called doctrine of executive necessity. In common law countries, it is generally accepted that a state or a state agency cannot by contract limit or disable

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[46] However, the application of this distinction to particular cases may cause problems. See David Allan and Mary Hiscock, above n 41, 198. To establish whether the promises made by governments are enforceable, courts need to look at factors that point the true intention of a government to enter to a legally binding contract and also may apply the doctrine of consideration: at 369.

[47] Robinson and Harvey discussed a number of cases where the public law and private law issues in government liability were addressed in Australian and other common law courts. See Mark Robinson and Ian Harvey, 'Private Law v Public Law: Issues in Government Liability' (Paper presented at a BLEC Conference, Melbourne, 4 May 1995).

[48] *IX Williston on Contracts,* Chapter XII (revised edition).

[49] In the cases *Horowitz v United States,* 267 US 458 (1925) and *United States v Winstar Co,* 64 F 3d 1531 (1995), the courts recognised that the federal government is immune from breach of contract liability whenever its public and general acts as a sovereign have the effect of violating the particular contracts into which it enters with private persons.

[50] In *Reilly v The King*, it was established that the state should be free to legislate in the interest of the public, and if the effect of a new legislation is to cause a breach of contract with a private citizen, the state ought not to be held liable for damages. (1934) AC 176 (PC).

[51] In the *Mengel Case*, the High Court dismissed liability claims against the Northern Territory Government on the ground that there was no misfeasance in public office. See *Northern Territory of Australia and Others v Arthur John Mengel and Others* (1995) 129 ALR 1 *('Mengel').*

its future executive action. The doctrine involves the idea that contracts or other agreements and promises are unenforceable in the public interest if they fetter or purport to fetter statutory executive discretions and powers.[52] In other words, it suggests that when there are conflicts, the government's responsibility to govern in the public interest can override its contractual commitments made with a private party.

The first well known case, where the doctrine of executive necessity is illustrated, is the English case, *Amphitrite*.[53] In that case, during the World War One, owners of a Swedish ship entered into an agreement with the British Government according to which the ship was obliged to carry sixty per cent approved goods to a British port and the British government was promised to issue a clearance in return. However, the British government denied the ship a clearance because of the exigencies of war. The owners of Amphitrite petitioned the Crown for damages for breach of contract. But the petition was dismissed on the ground that it was not competent for the government "to fetter its future action which must necessarily be determined by the needs of the community when the question arises."[54]

Although the decision was criticized on the grounds that it produced a highly unjust result,[55] it is very important in discussions of public contracts in English law.[56] The decision is the recognition that in a contract made with a government, rules and principles of ordinary private contracts may have no relevance. In the *Ansett Airlines Case,*[57] Mason J summarised the position of the common law with regard to a contract entered into by a government in the following way:

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[52] Mark Robinson, 'Executive Necessity: Upholding Contracts of Previous Government' (Paper presented at a BLEC Conference, Canberra, 1 November 1996).

[53] *Rederiaktiebrolaget Amphitrite v R* (1921) 3 KB 500.

[54] Ibid, 503.

[55] See, eg, writings of Australian scholars such as P W Hogg, 'The Doctrine of Executive Necessity in the Law of Contract' (1970) 44 *Australian Law Journal* 154 and Enid Campbell, 'Agreements about the Exercise of Statutory Powers' (1971) 45 *Australian Law Journal* 338.

[56] J D B Mitchell, *The Contract of Public Authorities* (1954) 27.

[57] *Ansett Transport Industries (Operations) Pty Ltd v Commonwealth* (1977) 139 CLR 54, 74-75 ('*Ansett Airlines*').

> "…the public interest requires that neither the government nor a public authority can by a contract disable itself or its officer from performing a statutory duty or from exercising a discretionary power conferred by or under a statute by binding itself or its officer not to perform the duty or to exercise the discretion in a particular way in the future. To take an example related to the case: the Commonwealth could not, by making a contract with an airline company whereby it promises that the Secretary of the Department of Transport would not for the next fifteen years issue to other airline companies import permits for aircraft, fetter the future exercise by the Secretary of the discretion conferred upon him by the Customs (Prohibited Imports) Regulations. The secretary must at all times deal with applications for import permits in accordance with the law; if he considers that, in conformity with government policy, the public interest calls for the importation of the aircraft, he should grant the application notwithstanding that the Commonwealth has entered into a contract which provides to the contrary. To hold otherwise would enable the executive by contract in an anticipatory way to restrict and stultify the ambit of a statutory discretion which is to be exercised at some time in the future in the public interest or for the public good".

The application of the doctrine of executive necessity creates considerable uncertainty for private parties contracting with a government. Therefore, a contrary tendency to make the government liable for undertakings made with a private party has been encouraged in common law jurisprudence. Where there is a breach of contract or some other default by the government and courts wish to find a right balance between the desirability of upholding the validity of contract and the need to preserve the free and unfettered exercise of the discretion, one solution to deal with this situation has been to make the contract with express statutory approval.[58] Thus,

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See also *West Lakes Ltd v South Australia* (1980) 25 SASR 389, 390 and an earlier English case, *William Cory v City of London* (1951) 2 KB 476, where the Court of Appeal held that a local authority could not be hampered in the exercise of its public health functions on the ground that it would affect its previous contractual obligations with a private individual.

[58] Mason J said:

"Where statutory approval for the making of the contract exists and the contract contains an undertaking that the statutory power will be exercised in a particular way, there is no room for the notion that the undertaking is invalid on the ground that it is an anticipatory fetter on the exercise of a statutory discretion. The contract, assuming it to be within constitutional power, is valid and the undertaking is free from attack." *Ansett Airlines Case,* above n 57, 77.

common law judges have struggled to find a workable solution to solve the conflict between private rights and governmental necessities.

But when one speaks of the lack of experience of common law courts in relation to contracts of governmental agencies, one should be mindful of one fact. The concept of administrative law, which on the Continent has been a separate branch of the law for over a hundred years, was unknown and denied in common law countries.[59] So was the idea of administrative contracts. Common law judges have not been specialized as administrative judges in French who only know contracts with a public authority, but never know contracts between private individuals.

However, because of the emergence of the "cabinet system" of government, common law countries needed to develop a comprehensive set of principles and rules dealing with administrative matters.[60] For the last few decades, a package of administrative legislation has been adopted in Commonwealth countries.[61]As a result of the development of administrative law, there has been a tendency in common law countries to place the administration, as regards its rights and obligations in a position which differs from that of an individual. This is evident in the law of contract. Common law countries have acknowledged that a contract made with an administration may differ from one which is made between two private parties at least in terms of formation and procedure.[62] More specifically, in the US government contract codes with more

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[59] Lord Diplock regarded the development of English administrative law 'as having been the greatest achievement of the English Courts in my judicial lifetime'. The House of Lords decision *Inland Revenue Commissioner v National Federation of Self-Employed and Small Businesses Ltd* (1981) 2 All ER 93, 104.

[60] Ian Ellis-Jones, *Essential Administrative Law* (2nd ed. 2001) 3.

[61] For example, in Australia the *Administrative Appeals Tribunal Act 1975*, the *Ombudsman Act 1976*, the *Administrative Decisions (Judicial Review) Act 1977* and the *Freedom of Information Act 1982* were enacted just in a decade. See Doogan, above n 11, 5.

[62] Whittaker wrote that English law is developing a recognisably distinct law of administrative contracts as at the level of substantive law contracts made by public bodies sometimes attract special legal controls, going beyond the traditional ones derived from *vires* of the public body concerned. See Simon Whittaker, 'Public and Private Law Making: Subordinate Legislation, Contracts and the Status of 'Student Rules' (2001) 21 (1) *Oxford Journal of Legal Studies* 103, 104.

detailed provisions regulating state contracts, which are similar to ones in civil law countries, have been adopted both in federal and state level.[63]

Lastly, it should be mentioned that modern common law theory also accepts the notion that bargains may change and be changed with time. As a matter of fact, doctrines such as frustration of purpose (in the UK) and impossibility (the USA) offer relief to contracting parties affected by unforeseen events. Lord Radcliffe interpreted the English doctrine of frustration as follows:

> "… frustration occurs whenever the law recognises that without fault of either party a contractual obligation has become incapable of being performed because the circumstances in which performance called for would render it a thing radically different from that which was undertaken by the contract. … It was not this that I promised to do…"[64]

Thus it can be said that the doctrines of frustration of contract and impossibility of performance are common law notions of the French theory of *imprévision.* Even though common law courts apply the doctrine regardless of the identity of parties or the object of the contract, the use of the doctrines in common law jurisdictions shows that the theory of *imprévision* is not a peculiar doctrine only present in French law. The use, scope and effect of the concepts can be different in each jurisdiction, but their basis is same which is they all deal with changes in the economic, legal and business realities underlying a contractual agreement.

The evidence seems to indicate that, although the concept of a distinct administrative contract is not present in common law systems, normal commercial law principles that apply in private transactions may have limited application to a transaction with a government. To reveal that there exists a separate category of contracts, the techniques of determining public law

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[63] Eg, the *US Federal Acquisition Regulation* (FAR) 2005-23 and *California Public Contract Code 2004*.

[64] *Davis Contractors v Fareham UDC* (1956) AC 696, 729.

contracts may be examined next followed by an attempt to draw outstanding features of public law contracts that differentiate them from contracts of private law.

1.2. The Distinction between Public and Private Law Contract

While the idea of a separate contract seems plausible in theory, practically, it is not always easy to draw a straight line between public law contracts and private law contracts. In fact, the identification of a contract as a public law contract affects issues regarding the enforcement and validity of arbitration clauses, choice of law clauses, and other clauses of the contract. Therefore, it is very important to distinguish public law contracts from those of private law.

1.2.1. THE METHODS OF DETERMINING PUBLIC LAW CONTRACT

To determine the public law character of a transaction various methods have been developed in court and arbitration practice. First of all, in legal systems where the concept of public law contract is well developed such as France, courts apply certain criteria to address the problem of identification of a *contrat administratif*. Similarly, in the context of the restrictive doctrine of sovereign immunity, municipal courts and international arbitrations have adopted some techniques separating the contractual and sovereign capacities of the government. The application of these two methods is now discussed.

(i) Criteria for determination of Administrative Contract

There are three criteria that French and German administrative judges may weigh to determine whether a contract in hand qualifies administrative contract. The three factors are: (1) the identity of parties, meaning at least one of parties needs to be of a sovereign nature; (2) the contract must have the community interest; and (3) the contract may contain clauses giving a unilateral capacity of modification by the government party.

Subject of the Contract

Under the theory of *contrat admisnistratif*, the public nature of state contracts is primarily due to at least one of the parties to these contracts being a state or state agency. In administrative law it is generally assumed that the administration can come to its decisions only for reasons of the public interest.[65] Therefore, proponents of the conception of administrative contracts often insist that in a public contract the administration represents the interests of the public, and every contract entered into by it is meant to perform some public service.[66]

However, in later decisions of administrative courts, the presence of public authority in the contract alone has become insufficient to regard the contract as public, since some of such contracts do not qualify for the real characters of state contracts in legal sense. For example, in the case of *Blaineau Pontamousson*,[67] the *Conseil d'Etat* held that although the contract between BAS (publicly-owned establishment) and a Public Office of Public Sector Housing on the hiring of building seems to be qualified as a public law contract, it is contract of private law because of its object. From this perspective, even contracts signed between two subjects of public law may not qualify as a public law contract, if the contract has an aim of the realization of private work, not public work. The contract thus should be subjected to private law.

In this connection, one should also distinguish those cases where transactions are signed by a state itself in its capacity as sovereign from those cases where transactions are concluded by a state enterprise or a separate legal person created by a sovereign. In the German case of OLG Celle,[68] it was stated that when the municipality is carrying on an activity which can by its nature also be undertaken on a civil law basis, it is up to the state how it organizes this activity. It may

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[65] George Vedel and Pierre Delvolvé, *Droit Administraf* (11th ed, 1992) 36.

[66] Mewett, above n 4, 225.

[67] *Bureau d'aide Sociale Blaineau Pontamousson*, Conseil d'Etat, Decision of 11 May 1990.

[68] OLG Celle NJW 1977, 1295 8 U 105/76.

choose either to carry on an enterprise in a relationship of equality of status (and therefore in the private law sphere) or to run it in the sovereign exercise of public power. The case thus suggests that a state entity or public corporation that performs a function on behalf of the state and in the public interest might have some special privileges by legislation[69] but may not qualify for the important characteristics of a state authority.

In fact, in domestic jurisdictions there is a general rule that splits away a state from its legal persons.[70] In *Rolimpex Case*, the issue was arisen whether a state enterprise can rely on *force majeure* when the government intervention caused its non-performance of the contract. In that case, the House of Lords held that in Polish law, Rolimpex is treated differently from the Polish State and that it could rely on the *force majeure* clause and claim that further performance of the contract was excused by the government intervention. [71] Former socialist countries also respected the legal separation between a state and its controlled state entity.[72]

However, one must admit that in the case of state contracts involving international elements, arbitrators take a more cautious view of the distinction. There is a fear that upholding the distinction in international investment contracts may cause injustice enabling state-controlled entities to cancel unfavourable contracts with foreign investors invoking *force majeure* based on the

[69] Eg, tax exemptions for a state entity.

[70] John Crook, 'Applicable Law in International Arbitration: The Iran – US Claims Tribunal Experience' (1989) 83 *American Journal of International Law* 278, 295.

[71] The House of Lords held that: "State-controlled enterprises, with legal personality, ability to trade and to enter into contracts of private law, though wholly subject to the control of the state, are a well-known feature of the modern commercial scene. The distinction between them, and their governing state, may appear artificial, but it is an accepted distinction in the law of England and other states." See *Czarnikow Ltd v Centrala Handlu Zagranicznego Rolimpex* (1978) 2 ALL ER 1043.

[72] As a soviet writer stated, "…from the political point of view, in the interest of peace and business relations between states, it is important to have always in mind that litigation arising from civil law relations which contains a foreign element, and particularly litigation related to foreign trade organizations and firms of the different countries, are not international disputes, but disputes of civil law." See L A Lunts, *Mezhdunaodnoe Chastnoe Pravo* (1970) 173.

government intervention. Therefore, in the international context, there is a tendency not to separate a state entity from the state.[73]

Object of contract

To qualify fully for the characteristics of a public law contract, the nature of the service provided by the contract is crucial. State contracts serve the needs and benefits of the whole population. Under this criterion, thus, a contract is regarded as administrative, if the obligation of the contract is the execution of public work. A general rule is stated in the German case:

> "It is not simply the public law nature of the tasks, the public interest pursued by the activity or the consideration of community interests which is determinative for differentiating between civil law and public law areas of action."[74]

Because of their unique importance to society, a few industries have been recognised as a special category of public utilities for over a century. The most common industries classified as public utilities include telecommunication, electricity, gas, water services and public transportation.[75] The mission of public utilisation is the most important characteristic of administrative contracts because sometimes the execution of work for the public benefit alone is sufficient enough factor to acknowledge the contract as public law contract.

Particularly, in the case of Société *enterprise Peyrot*[76], the state signed a contract with a company of the Motorway Esterel Cote Azure, at the end of which the company built motorways: it was a public service contract by the determination of the law. Then, there was

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[73] In a number of arbitration awards, state entities were denied the revocation through *force of majeure* based on the government action. Eg, *Air France Case*, Cour de Cassation, Decision of 15 April 1970; ICC Award in Cases 3099 and 3100, Award of 30 May 1979 (1979) 7 YCA 87; *Himpurna California Energy Ltd (Bermuda) v PT (Persero) Perusahan Listruik Negara (Indonesia)*, 14 *Mealey's International Arbitration Reports*, A-26 (December 1999).

[74] OLG Celle NJW 1977, 1295 8 U 105/76.

[75] But public services may vary depending on the economic and social developments of states. The special public utility classification in any country can be derived from its investment code, constitutional provisions and administrative regulations. For example, in 2001 Mongolian Parliament approved a nationwide construction project "Millennium Road" to promote economic development and improve the living standard of people. Because of its strategic importance to national economy, the construction project was defined as services of public necessity.

[76] *Société enterprise Peyrot,* Tribunal des Conflits, Decision of 8 July 1963.

another contract between the Esterel Company and a Peyrot Company which was charged to build certain public works. The *Tribunal des Conflits* (court of the Conflicts) qualified this contract as administrative because private organisation A acts in the place of the state and because, to some extent the contract arose out of the other contract. The case shows that even a contract between two people of private law may be considered as a public contract, if at least one of them has been given a mandate by the public person to carry out public work. In that case, the legal status of the contracts passed by private people may be interdependent with the principal contract signed by the public power.[77]

c). The presence of Exorbitant Clause

Some contracts may contain exorbitant or derogatory clauses of common right which make the contract administrative. In French jurisprudence, exorbitant clauses are defined as clauses excluded in their nature from private relations and stipulated obligations which cannot appear in a similar contract of private law.[78] In some circumstances, the clauses create inequalities between parties to the contract, by conferring on the public person a superiority compared to the private person.[79]

The goal of the clause is to place the one under the authority of the public person. For instance, a local government can contract with a private party on the opening of a restaurant in its building, quoting clauses which put precise obligations on the private party such as an obligation to put on sale stocks at the request of the administration and to cease the exploitation as soon as the local authority asks it. For certain contracts, one knows in advance that the

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[77] For more about this, see Stéphanie Clamens, *Distinction between Public Service Contracts and Contracts of Private Law to the Glance of Jurisdictional Dualism* /translated version / <http://www.rajf.org/articles/10042001.php > at 11 November 2005.

[78] See George Vedel, *Notice on the Concept of Exorbitant Clauses in the Evolution of Public Law*, Studies in the Honour of Achilles Mestre, Sirey (1956).

[79] In the case of *Société du Vélodrome du Parc des Princes*, a public person had a right to control the financial result of the contract. See *Société du Vélodrome du Parc des Princes, RDP*, Conseil d'Etat, Decision of 26 February 1965.

contracts are public law contracts because the law defines these contracts as administrative contracts. It is the case with the contracts of partnership.[80]

Nevertheless, the criteria that are used to determine the legal nature of the public law contracts are not always helpful, when it concerns a specified case. Sometimes, it may be difficult to establish the status of the contract according to one or more criteria alone. Therefore, to determine whether the contract concerned is a public law contract or a private law contract, one may need "to contemplate the whole surroundings, the parties, the nature of the administrative organization with which the contract is made, the nature of the service, and the terms of the contract itself and the conditions on which it is made."[81]

Taking into considerations these discussions, public law contracts can be defined as contracts where government or a public authority engages with a private party for the execution of essential public service functions such as constructing infrastructure or establishing industrial complexes for its people. In this connection, ordinary public procurement contracts, which could be defined as the purchase of goods and contract services for the consumption of the government, ministries and other public agencies should be excluded from the category of public law contracts. The reason is that the procurement contracts do not benefit the general public, but only those public agencies that requested the service.

The concept of administrative contract and the criteria of distinguishing public contracts from the private ones however have not produced uniformity of practice because of the unfamiliarity of this doctrine in other jurisdictions. But criteria adopted in the context of the restrictive doctrine of state immunity for purposes of determining immune and non-immune acts of a state seem to be more commonly accepted in the international practice. Thus they may

[80] The *2004-559 Act* defines Partnership Contracts as administrative contracts. See Art 1 of the Act.

[81] Mitchell, above n 56, 167.

provide practical guidance as to which activities of a state are of sovereign character and which are not.

(b) Criteria adopted in the Restrictive Doctrine of Sovereign Immunity

In legal regimes, which have a single approach to a contract, arrangements made with a government are governed by precisely the same rules as any ordinary contract made between private persons. The only difference may be the application of some procedural rules that apply in case of government contracts. Therefore, courts in common law countries have generally no need to distinguish aspects of public law character and private law character when dealing with disputes arising out a government contract.

However, in certain circumstances, the presence of a state party in a contractual dispute may raise an issue whether the government party to a contract acted in its sovereign capacity or non-sovereign capacity. The identification of the state party's status in the contractual relationship has important legal implications. The rules of law which are applicable to this relationship and the issue of prerogatives, immunities, and responsibilities are all dependent on the state party's status.

In making a distinction between governmental and commercial acts, courts both in Europe and the US have adopted two tests. One is the purpose test which requires courts to look at the purpose of the act to qualify it as governmental. In *Kingdom of Roumania v Guaranty Trust Co*, applying the purpose test the court held that the purchase of boots for the army is a governmental transaction.[82] The application of this test has proved undesirable from the restrictive theory leading to the characterization of most transactions by government as public acts. Therefore, it has been replaced by the nature test which requires the examination of the

[82] *Kingdom of Roumania v Guaranty Trust Co*, 25 F 2d 341(1958).

nature of transaction concerned. In one case, the German Federal Constitutional Court stated that:

> "The distinction between acts *jure imperii* and acts *jures gestionis* can only be based on the nature of the act of the state or of the resulting legal relationship, not on the motive or purpose of the state activity."[83]

The trends in European and American legal systems give increasing support to the nature test characterizing most transactions by governments as commercial acts.[84] As a result, it is possible that foreign investment agreements such as agreements for the exploitation of natural resources which involve matters of public interest could be wrongly classified as activities of a private nature. In fact, such contracts in no way can be equated to other commercial contracts.

Therefore, now it is proposed to combine the nature test and the purpose test. In particular, according to the initial 1984 *Draft Convention on the Jurisdictional Immunities of States and their Property,* the issue whether a transaction is commercial is determined by the nature of the transaction rather than the purpose. However, later in 1991 it was rewritten that "reference shall be made primarily to the nature of the transaction, but the purpose of that transaction shall also be taken into account if, in the practice of that state, that purpose is relevant to determining the non-commercial character of the contract".[85]

To date there seems no clear concurrence in state practice on how to draw the line distinguishing government transactions from private ones. The best way to show how public law contracts differ from contracts of private law is to contrast these two types of contracts.

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[83] *Empire of Iran*, German Federal Constitutional Court, 30 April 1963, UN Legal Materials 282; 45 ILR 57, 80.

[84] Ian Sinclair, 'The Law of Sovereign Immunity: The Recent Developments' (1980-II) 167 *Hague Recueil* 113, 114; Congressional Committee Report on the Jurisdiction of United States Courts in Suits Against Foreign States (1976) 15 ILM 1398, 1406.

[85] International Law Commission, *Draft Convention on the Jurisdictional Immunities of States and their Property,* Doc A/CN.4/462; A/C.6/40/L.2 YBILC (1991) II part 2, 13.

1.2.2. PUBLIC LAW CONTRACTS V PRIVATE LAW CONTRACTS

Being a distinct type of contract, public law contracts undermine some traditions and values of contract law. First of all, the conception of *contrat admisnistratif* deviates from the sanctity of contracts, which is a fundamental precept of contract law, as in administrative contracts the public interest may override individual rights. As Fatouros observed, "public contracts are subject to the overriding interest of the public, as conceived in good faith by the state".[86] The general principle established in major legal systems is that a government has a unilateral power to modify or terminate its contractual obligations if the public interest so requires.[87]

On the other hand, from a legal point of a view, a state-citizen relationship cannot be pure matters of contract. Dealing with the contention that there was a contract between petitioner and the government, the Supreme Court of India stated in the *Roshanlal Tandon v Union of India*:

> "… it is obvious that the relationship between the Government and its servant is not like ordinary contract of service between a master and servant. The legal relationship is something entirely different, something of the nature of status. It is much more than a purely contractual relationship voluntarily entered into between two parties. The duties of status are fixed by the law and in the enforcement of these duties society has an interest." [88]

Likewise, Mewett wrote, "any person who enters into a public contract becomes, merely through being in that position, immediately subject to the powers of supervision of the administration. The contract is a prerequisite to the control, but the control is in no way contractual."[89] These statements suggest that parties to a state contract are bound by statutes

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[86] A A Fatouros, *Government Guarantees to Foreign Investors* (1962) 269.

[87] See the earlier discussions in Section 1.1.2 (Comparative Law on Public Law Contracts) of this Ch.

[88] *Roshanlal Tandon v Union of India* AIR (1967) SC 1894.

[89] Mewett, above n 4, 225.

rather than their own free choices. In contrast, the free choice of individuals to make a contract on their own terms is a core feature of contract law.

The next difference between the two types of contracts lies in the inherent inequality of parties both from legal and economic point of view. In administrative contracts, the state is legally in a superior position. This means that the state could vary the other party's liabilities under the contract or even could terminate the contract if its performance is no longer in the interest of the state.[90] The other party to a state contract is mostly a multinational corporation, which holds a huge economic power.[91] The existence of such inequalities is contrary to the fundamental principle of mutuality of contract law, especially that of common law.

In addition, their contracts are different in that parties to a state contract pursue different interests. While, in pure private contracts, both parties' interests are profit motivated, in state contracts the state party represents not its own interests but the interests of the public.[92] Exactly the idea that a state acts in the public interest allows a government to override existing private or legal rights including those rights emanating from contract. Thus, when there is a clash of interest, the public interest prevails over the private interest meaning that a state would sacrifice commitments to private parties in order to serve the public interest.

Furthermore, one of the distinguishing characteristics of state contracts especially foreign investment contracts is that the performance of such contracts requires a long term relationship. The long duration of these contracts makes them particularly susceptible to political or economic

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[90] Prof Mitchell stated: "The special purpose for which governmental agencies exist, the service of the community, requires that on occasions those agencies must be released from, or may be able to override, their obligations… This limitation of the obligation of contract depends not upon the acceptance of any particular theory of political philosophy but upon practical necessity." See Mitchell, above n 56, 222.

[91] Sales and net profit figures for some multinationals are higher than GNPs of developing countries, like for example the annual sales of Shell are roughly £68billion, which is two and half times the income of Nigeria's 110 million people. *Are Multinationals too Powerful? What can be done about Their Power?* Angelfire <http://www.angelfire.com/sc/iressays/Multinationals.html> at 23 January 2008.

[92] Mewett, above n 4, 224.

influences which are unenforceable at the time of contract conclusion.[93] Thus, they are more accessible to the doctrine of *rebus sic stantibus*. By contrast, in private contracts courts tend to uphold the validity of an agreement and restrain in intervening into the negotiated terms.

Finally, they have different fields of operation. The activities of state contracts are integrated in the territory of the host country, so the application of domestic law of the state has a primary importance. It is a common concept that any person who enters the territory of a state as a foreigner is expected to abide by its laws. On contrary, parties to international commercial contracts usually operate outside the territory of the host state. Therefore, they could avoid, by choosing another legal system, the application of domestic law of the state unless it is mandatory. Admittedly, these characteristics of administrative contracts are just notable ones. There may be other differences such as a procedure for making the contract, its form and so on.

1.3. Summary of Findings

This chapter has mostly sought to examine the position of state contract in two major legal systems and provide an overview of its legal nature. Because the rest of the thesis will be based on the concept that is taken to the legal nature of the contract, this is a very important issue. It would be meaningless to argue for the law governing state contract unless a consensus on the legal nature of state contract is established.

The legal regime of a country whose government signed a foreign investment contract is crucial to determine the nature of the contract, the rights and obligations of parties and the whole other issues surrounding the contract. Some national laws (France and other civil law countries of EU) have more advanced concepts towards the public service contracts. In these countries, it is generally accepted that the obligations under state contract are defeasible in the public interest. This view has led to the development of a theory that recognises the specificity of

[93] Klaus Berger, 'Renegotiation and Adaptation of International Investment Contracts: the Role of Contract Drafters and Arbitrators' (2003) 36 (4) *Vanderbilt Journal of Transnational Law* 1347, 1348.

government contracts. The concept is more comprehensive in France than any other country and known as the *theorie de contrat administratif*.

The theory recognises concepts that are absent in ordinary contract law. Under the concept of *l'Imprévision*, if the economic equilibrium of the contract is called into question due to the occurrence of an unforseen event at the time of conclusion, either the administration or the private party has a right to fix contractual terms or revoke the termination of the contract. Another concept, *fait du prince* enables the private party to an administrative contract ask for compensation, if the new legislation or administrative act results in exceptional increase in the costs of his contractual obligations.

Therefore, one cannot say that *contrat administratif* is biased in favour of the government party to the contract. The whole idea of developing the concept of administrative contract is to balance the interests of private parties with those of the public agency. On the one hand, the public agent can modify the contract unilaterally in the public interest. On the other hand, the private party is protected from exceptional loss. The theory thus would be the classical doctrine which could be extended to the case of foreign investment contracts.

The substantive basis of the notion of public law contract also exists in other countries with a civil law tradition. More specifically, the national law equivalents of the doctrine of *rebus sic stantibus* that justify intervention into negotiated terms of contact in cases of substantial change are more strongly supported in cases where contracts are made with a state or a state agency and embody not only commercial, but also administrative, state-related elements.

On the contrary, common law countries have a single contractual approach meaning that there is conceptually no difference between a contract made with a state and a contract made between two private parties. The general principle established in American, English and Australian judicial practice is that a government is bound to carry out a contract it has lawfully

and properly entered into. However, there is every reason to suppose that in common law jurisdictions a contract made with a public agency has a somewhat different nature which may not be reflected in an ordinary contract.

First, the doctrine of executive necessity in common law countries forbids a government from being bound by a contract which fetters statutory executive discretions and powers. In addition, in common law contracting with a government became a restricted process as the countries are adopting detailed rules regulating government contracts similar to administrative contract codes in civil law countries. Finally, in common law countries it is accepted that changed circumstances of a contract which were unforeseen at the time of conclusion of the contract can excuse non-performance. Again the result is similar to the French theory of *l'Imprévision* which allows parties to an administrative contract to make adjustments in case of a new economic event upsetting the financial equilibrium of the contract.

To sum up the findings of comparative law on the notion of public law contract, it is evident that elsewhere state contracts are treated not exactly as ordinary civil law contracts. In other words, all legal systems share the basics of the notion of administrative contracts. But the theory seems at a different stage of development in each national law.

CHAPTER TWO: STATE CONTRACTS IN THE FOREIGN INVESTMENT SECTOR

2.1. International Law and State Contracts

The notion of state or administrative contracts, which is acknowledged in the most developed municipal systems, is even more uncertain and controversial when it comes into the field of international law. The uncertainties and controversies are partly due to the fact that international law never dealt with contractual relationships involving private parties and partly due to the theory of internationalisation of state contracts which undermines public law features

of the contracts. The term "a state contract" first was introduced in the international legal system only in the latter part of the twentieth century.[94] Since then it has received much attention in scholarly writing and judicial practice in the context of the theory of internationalisation of state contracts. Before this time, international law knew only one type of state contract, which is a concession contract. But the traditional concession contracts were a matter of the municipal legal system rather than a matter of international law.[95] Therefore, there was no a need to develop the notion in the context of the "law of nations".

2.1.1. THE STATUS OF STATE CONTRACTS IN ARBITRATION OF INVESTMENT DISPUTES

When the legal environment of traditional concessions was changed to a considerable degree due to the dissolution of colonialism, international arbitration practice in the 1950s developed the theory of internationalisation, and brought disputes arising from a contractual relationship between a state and foreign private party under public international law. The new type of arbitration mechanism which emerged was a hybrid system combining features of both public international law arbitration between states and private international law arbitration between private commercial parties.[96] Thus, having a mixed character, the investor/state

[94] The term "state contracts" is quite new formula, which had appeared in the international legal literature since 1944 as this term was coined by Mann in his article. See F A Mann, 'The Law Governing State Contracts' (1944) 21 *British Year Book of International Law* 11.

[95] Hitherto that every contract, which is not an international agreement, is subject to some municipal law is affirmed in the *Serbian Loans Case (France v Serbia)* [1929] PCIJ (ser A) No 20, 41.

[96] Investor-State arbitration differs in material respects from ordinary private international commercial arbitration. Mustill and Boyd warned against reliance on generalized authorities to different types of arbitrations:

"… when considering a reported case it is necessary always to bear in mind the type of arbitration with which it was concerned. Decisions and statements of principle, which were perfectly valid at the time, and remain good law today, may nevertheless yield completely false results if applied in a different context. A commodity arbitration on quality and a formal reference pursuant to statutory powers are both examples of arbitration, but they are barely recognizable as the same process, and attempts to transfer principles from one to the other will inevitably lead to error". Michael Mustill and Stewart Boyd, *The Law and Practice of Commercial Arbitration in England* (2nd ed, 2001) 54.

arbitration could have coalesced principles of these two types of arbitration into one single structure.

Nonetheless, the arbitration developed in the context of theory of internationalisation of state contracts predominantly utilised principles of international commercial law, and largely undermined assumptions about sovereignty of the host state in regulating its own matters in accordance with public international law. Under the arbitration proceedings, a state did not differ from a private commercial party and they both were treated as equals in their capacity as parties to a private contract. Since the investor/state arbitration originally emerged as a method of investment protection,[97] rules which favour a foreign investor gained support.

On the contrary, rules which may represent a risk to a foreign investor were rejected by the opponents of the internationalisation of state contracts. The theory of the public law contract thus was the first principle the earlier arbitrators avoided. They claimed that the theory of administrative contract is a unique exception rather than a common approach. Prof Dupuy stated:

> "One should take into account the fact that the theory of administrative contracts is somewhat typically French: it is consecrated by French law and by certain legal systems which have been inspired by French law. But, it is unknown in many other legal systems which are as important as the French system and it has not been accepted by international law…"[98]

In fact, the arbitrator's statement was not true. Mitchell found "many similarities in the treatment of public contracts even under systems of law which have different origins and operate in different constitutional surroundings".[99] *A*lso in *the BP Arbitration*, Lagergren J acknowledged

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[97] Muthucumaraswamy Sornarajah, 'The Climate of International Arbitration' (1991) 8 (2) *Journal of International Arbitration* 50.

[98] *Texaco Overseas Petroleum Company and California Asiatic Oil Company v Libya* 53 ILR 309 (1977) ('*Texaco Award*'), para 57.

[99] Mitchell, above n 56, 220-221.

the commonality of principles applicable to state contracts in legal systems.[100] Thus, the deficiencies of some legal systems such as common law in dealing with state contracts ought not to mean complete rejection of the notion of state contracts by international arbitrators.

With the refusal of the theory of administrative contract in investment contracts, other principles which may support renegotiation and adjustment of contract also were denied. For example, the doctrine of *rebus sic stantibus* which applies in municipal law when changed circumstances affect the basis of contracts was not accepted for long in the international arbitration of investment disputes. The proponents of the theory of internationalisation have argued that in a contract between a state and an alien, the use of the sovereign authority of the state, contrary to the expectations of the parties, to abrogate or violate a contract with an alien, is a violation of international law. [101] Therefore, the earlier arbitrators insisted on the application of the *pacta sunt servanda* which prohibits altering an international agreement for any reason except by mutual consent.[102]

In actual practice, however *rebus sic stantibus* has a same legal value as the doctrine of *pacta sunt servanda.* It is not just a principle that is accepted by civil law countries, rather it is a universally recognised legal doctrine initially applied in international treaties.[103] In common law countries, the court-constructed doctrines of 'frustration, impossibility and impracticability' have similar result to *rebus sic stantibus*.[104]

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[100] See *British Petroleum Exploration company v Libya* 53 ILR 296 (1977) ('*BP v Libya*'), 349.

[101] See Steven Schwebel*, International Arbitration: Three Salient Problems* (1987) 111.

[102] The strict application of *pacta sunt servanda* to a state/foreign investor relationship has raised sovereignty-related issues. See Waelde and Ndi, above n 2. They discussed the doctrinal debate between the application of *pacta sunt servanda* and the encroachment on national sovereignty over domestic law making in the context of international investment commitments.

[103] *Vienna Convention on Law of Treaties,* opened for signature 23 May 1969, 1155 UNTS 331, Art 62 (entered into force 27 January 1980).

[104] Saliba, above n 29.

The perspective of international arbitrations of investment disputes deviated from municipal law traditions dealing with state contracts has sown the seeds of legal crisis. After more than a half century, there is still disagreement whether international law is supposed to deal with the issues of contract law or whether there exists any rule or principle of international law that deals with the contracts. The legal environment of foreign investment has been highly uncertain, when a stable and transparent legal environment of foreign investment is essential factor for economic development of the globalised world. Many attempts to negotiate multilateral investment agreements so far have failed.[105]

It seems that the uncertainty and confusion that exist in system of international investment arbitration would be cleared up if the arbitrators would accept the public law considerations of state contracts. In this sense, international law on foreign investment, instead of offering pure commercial principles that govern private transactions between individuals, ought to take up the legal theories of municipal legal systems reconciling legitimate state interests with individual interests such as those that govern public law contracts. Many academics have pointed out that international law should recognise public law features present in state contracts.[106] Besides, the creation of norms of permanent sovereignty over natural recourses has contributed greatly towards a more balanced view that recognizes a certain degree of a state power in contracts of public importance.[107]

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[105] See nn 11 and 37 of Part Four and accompanying texts.

[106] Chukwumerije for example argued that state contracts are a component of public interests of the state party; therefore, legal rules specially designed for commercial contracts involving private parties cannot be applied to state contracts. Further he questioned why a general approach that public interests are more valuable than the private needs of single party cannot be transferred in the area of State contracts. Okezie Chukwumerije, *Choice of Law in International Commercial Arbitration* (1994) 146. See also Philippe Kahn, 'Law Applicable to State Contracts: The Contribution of the World Bank Convention' (1968) 44 *Indiana Law Journal* 1, 20-23; Muthucumaraswamy Sornarajah, *International Commercial Arbitration: The Problem of State Contracts* (1990) 80; A F M Maniruzzaman, 'International Development Law as Applicable Law to Economic Development Agreements: A Prognostic View' (2001) 20 *Wisconsin International Law Journa1* 1, 31.

[107] See further discussions in Ch Six, Section 1 – Development of New Principles Reflecting Sovereign Power.

2.1.2. MOST COMMON TYPES OF FOREIGN INVESTMENT CONTRACTS

State contracts in the foreign investment sector can cover a wide range of issues, including loan agreements, purchase contracts for supplies or services, or large infrastructure projects, such as the construction of highways, ports or dams. The problem of choice of law greatly depends upon the particular type of foreign investment contract under discussion. In some contracts such as concessions and joint venture agreements, the relevance of domestic legislation is greater than international law. By contrast, in technology transfer agreements and loan contracts, the application of law other than the host State's is more relevant. Therefore, it is important to look at types of investment contracts and investigate their nature before choosing an applicable law.

Concession agreements

The most popular form of cooperation between a state and foreign private party has been the natural resource exploitation contract, commonly referred to as a "concession agreement". Concession contracts have two major features. First, it is the oldest form of a state-alien commercial cooperation. A second feature is that this is the area of state contracts, where the ideological battle between the North and South bloc countries has reached the hottest point of intensity. This may be because in concession contracts a state party is mostly a developing state of the Middle East, Latin America, Asia or Africa, which is wealthy in natural resources but lacks technology and cash flow, while the other party is a corporate citizen of any of the developed nations who needs ready sources of raw materials, and has good technology and money as well.

The concept of concession may be defined differently in legal systems, but the concession in its general sense of the word implies a mere permit from the appropriate state authority given to a foreign person to conduct economic activity on the state's territory. In the

narrow sense of the word, the concessions can be construed as a unilateral act of a state that authorizes foreign private parties to carry on economic activities in the interests of its economic development.

Traditionally, concessions constituted the usual type of contracts in the field of oil production industry. Oil concessions in world practice have over a 100-year history.[108] The legal nature of the concessions did not raise any difficulties until the collapse of colonialism in mid 1950s, because there was a clear consensus among states that a concession contract is an obligation that is regulated by municipal law and is not an international agreement.[109] However, the internationalisation theory of state contracts "invented" in this period proposed a different approach subjecting these contracts to international law. As a result, there has been a disagreement over choice of law issues for last sixty years. In the next chapters the origins of the debate, as well as the theory itself, will be more fully discussed.[110]

From the legal point of view, the traditional concessions seemingly were not an actual contract, since these contracts lacked the basis of free agreement. First of all, the relationship between the host state, which was usually a colonial country or a less developed state, and the concessionaire who were the citizens of the imperial states had an inherently unequal and unfair nature. Zoloeva pointed out the following distinctive features of the old concession contracts:[111]

- grant of a permit by the host country to the foreign company for oil production in the territory transferred to concession;

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[108] The first formalised legislative concessions appeared as early as in the XVIII century, particularly, in France. But it is generally acknowledged that the first concession in the history was issued to William d'Arcis in Persia in 1901 (known as "d'Arcis concession"), though in literature one may come across the mention of early concessions in the former Dutch West Indies. See Yana Zoloeva, 'Will the Concession Agreement Become One of the Possible Legal Forms to Exploit the Subsoil in Russia?' (2000) 1 *Russian Energy Law Journal* 5, 7.

[109] *Serbian Loans Case (France v Serbia)* [1929] PCIJ (ser A) No 20, 41.

[110] See Ch Three- 'Evolution of the Theory of Internationalisation as Choice of Law Rule' and Ch Four- 'Controversies in the Theory of Internationalisation'.

[111] Yana Zoloeva, above n 108, 6.

- a large territory of concession, covering in certain cases the entire territory of the country or, at least, the most promising in terms of oil production;
- an extended term of concession (up to 99 years);
- absence of provision to return to state ownership unused and non-promising mineral wealth segments before the maturity of the concessions;
- full and sole control by the concessionaire of all aspects of economic activity;
- practical estrangement of the host state from participation in the management of the concession;
- direct financing by the foreign company of all exploration works within the framework of concession;
- Insignificant financial deductions from the concessionaire's earnings in the favour of the host state, which were confined, as a rule, to a symbolic fee for the right to develop mineral wealth, in the form of fixed production charge at the maximum rate.

Because of such unjust terms, under the old concession system, foreign investors were rewarded handsomely, while a host government made very little profit. For example, in 1903 a British engineer, William Knox D'Arcy was granted a concession by Persia's Shah (modern Iran). By 1933, his company (the Anglo - Persian Oil Company) had made a profit of 200 million pounds sterling, whereas Persia had received only some 10 million of the 32 million pounds sterling which it was entitled by the concession.[112]

The provisions inherent in the traditional concession contracts, which were disadvantageous for the host states, have been dramatically changed due to the political changes brought by World War Two. Most importantly, the end of colonialism during the mid 20th century has significantly contributed to the establishment of equal and just relations among different states, regardless of size, wealth, or military power. As a result, modern day concessions greatly differ from the traditional ones.

First, the terms of modern concessions are more balanced compared to the traditional ones. In the new concession model, the government provides on a compensated basis a licence

[112] See Middle East and Africa Encyclopedia, *British-organised Oil Company based on a Concession Agreement with the Shah of Persia* < http://www.answers.com/topic/anglo-iranian-oil-company > at 26 February 2008.

to extract useful minerals, and the investor extracts the mineral and owns it and pays the government taxes, royalties and other fees in return. Plus, in the modern system, a mining title-holder is subject to a range of obligations such as reporting, compliance with environmental and social regulations, and employment requirements.[113] Lastly, the duration of modern concessions is relatively short compared to early ones.[114]

The 'modernised' concession contracts are now widely used in most countries of Africa and Latin America and some countries of Asia as well as in developed countries such as the USA, Australia, Canada and Norway. However, Norway's experience is more interesting and could provide an example for other countries in the structure of natural resources industry, thus it is worth discussing. Before talking about the model, some features of the Norwegian oil industry should be noted. First, Norway has a relatively young oil industry, which was first discovered in the mid 1960s.[115] Learning from previous experience in other oil-rich countries, Norway has established a legal framework which could provide long term revenue and benefits for the country.[116] The regulatory framework for petroleum activities in Norway is conferred by the *Petroleum Activities Act* (1996) and *Petroleum Activities Regulations* (1977).

Second, prior to the discovery oil Norway enjoyed comparatively strong economic growth, full employment and a current account surplus, and therefore it was in no hurry to

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[113] Eg, *Minerals Law of Mongolia* (1997) Ch Four.

[114] Eg, in Tanzania a mining license is granted for 25 years and can be renewed for up to 25 years. See *Mining Act* (1998).

[115] Official Documentation and Information in Norway (ODIN), *Norwegian Oil History in Brief* (2004) <http://www.dep.no/filarkiv/176322/Fact0103.pdf > at 21 December 2006.

[116] The legal framework provides:

> "…resource management of petroleum resources shall provide revenues for the country and shall contribute to ensuring welfare, employment and an improved environment, as well as strengthening of Norwegian trade and industry and industrial development, and at the same time take due regard to regional and local policy considerations and other activities." *Petroleum Activities Act*, ss 1-2.

develop the petroleum resources.[117] This comfortable economic situation formed the basis for a strong bargaining position in relation to the international industry and enabled the Norwegian government to develop a rational, competent petroleum policy and impose obligations other than just taxation on the oil companies.[118] The Norwegian government also has ensured that the high local content is achieved in activities. Currently, Norway has entered into Bilateral Investment Treaties with 16 countries, none of which are developed states.[119]

The Norwegian model looks like a mixture of a concession and a joint venture agreement. The award of the production license is conditional upon the parties concluding a Joint Operating Agreement (JOA).[120] The JOA is a contract between the Norwegian state and the participants in a license, and forms the core regulatory document for petroleum production under the license. The JOA regulates:

- the structure and arrangement of the JOA, including parties, the State appointed operator, voting rules, and allocations;[121]
- financial arrangements, including how joint assets are arranged, liabilities and payments;[122]
- actual work activities, especially work programs, budget of the project, rules relating to purchasing, and insurance coverage for participants;[123]
- field development proposal;[124]
- procedure and information relating to sole risk operations;[125]

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[117] Oystein Noreng, *Norway: Economic Diversification and the Petroleum Industry* (2004) Middle East Economic Survey < http://www.mees.com/postdarticles/oped/a47n45d01.htm > at 23 December 2006.

[118] Noreng, ibid.

[119] ICSID, Database of Bilateral Investment Treaties < http://icsid.worldbank.org/ICSID/FrontServlet > at 23 February 2008.

[120] *Petroleum Activities Act 1996* (Norway), s 3-3.

[121] *Joint Operating Agreement concerning Petroleum Activities*: *18th Licensing Round* (2005) Arts 1-6.

[122] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Arts 7-11.

[123] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Arts 12-15.

[124] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Arts 16-17.

[125] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Arts 19-20.

- the disposal and distribution of petroleum produced, including ownership of resources;[126]
- issues relating to assignment of participating interest, cessation of operations, especially duties and obligations relating to cessation, and abandonment of facilities[127].

The Norwegian law also requires that a management committee must be established to manage the petroleum operation, and is the supreme body of the joint venture.[128] Each participant has one member and one deputy on the management committee, which is chaired by the operator or his deputy.[129] The voting rules for the management committee are governed by the participating interest (percentage) each party has, and decisions are ratified when a certain percent of members agree.[130]

However, it should be noted that the concession is not only option for the structure of exploitation of natural recourses. Apart from the concession model, two other models have been commonly used in the field of exploration of minerals, which are the fixed fee agreement and the product sharing agreement. Under the fixed fee agreement or service contract model, investors are hired for to carry out certain services such as extraction of minerals for a limited period of time and for which they receive a fixed fee. In this model, the state is the owner of the extracted raw materials. This model has been the case throughout most of the Gulf region since the early 1970s.[131]

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[126] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Arts 21-22.

[127] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Arts 24-33.

[128] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Arts 1-1 and 1-4.

[129] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Arts 1-2 and 1-3.

[130] *Joint Operating Agreement concerning Petroleum Activities: 18th Licensing Round* (2005) Art 2.

[131] Greg Muttitt, *Crude Designs: The Rip-off Iraq's Oil Wealth'* (2005) Global Policy Organisation <http://www.globalpolicy.org/security/oil/2005/crudedesigns.htm > at 25 December 2007.

Today, in the sphere of exploitation of natural resources product sharing agreements (hereinafter PSAs) have received wide applications.[132] PSAs are a form of cooperation between an investor and a state in the process of the use of the subsoil. In a PSA contract, a host country grants a foreign investor the right to explore and develop a specified area for a limited duration of time, in exchange for a percentage of the actual oil produced. When oil is produced, the foreign investor is allotted enough oil to cover the costs of the project (cost oil), and whatever is left is divided between the foreign investor (profit oil) and the host state (government take) according to a pre-determined percentage negotiated in the PSA contract.[133]

The PSA initially was promoted by developing states that wanted a fair share in their mineral development,[134] however now has became a preferable option for oil companies and their home states. Key attractions of production sharing agreements to private oil companies are that relations between the host government and investors are governed by private law principles, a "stabilisation clause" may be inserted protecting investors from future adverse legislation, and the right of the host government to terminate a PSA is restricted, unlike under the licensing regime.[135] In other words, the PSA regime treats a state agency and an investor equally.

However, the contractual system of subsoil use is unlikely to become a full-fledged civil law contract, where both the state and investor stand as equal parties. In relations to subsoil use arising on the basis of a PSA, the state acts in two roles.[136] On the one hand it fulfils its

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[132] The model is used in more than 40 countries, including Angola, Vietnam, Libya, Egypt, Malaysia, Peru, Syria, the Philippines, and Equatorial Guinea as well as in transition countries such as Russia, Azerbaijan and Kazakhstan. Irina Paliashvili, *The Concept of Product Sharing* (1998) Ukrainian Legal Group <http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm> at 11 July 2006.

[133] See Ernest Smith and John Dzienkowski, 'A Fifty-Year Perspective on World Petroleum Arrangements*'* (1989) 24 *Texas International Law Journal* 13, 28.

[134] Product Sharing Agreements (PSAs) as a special form of service contracts were first used in 1967 in Indonesia. See Kassan Hossain*, Law and Policy in Petroleum Development* (1979) 138.

[135] Alexei Bardin, 'The View of Foreign Investors on the Subsoil Licensing Regime and Related Risks in Russia' (2003) 1 *Russian/CIS Energy and Mining Law Journal* 7.

[136] Paliashvili, above n 132.

obligations under the agreement, and on the other hand it preserves its state public-legal functions. When these roles converge or come into conflict with each other, one should be guided by the principle that, within the scope of conditions provided by the agreement, the state and the investor are equal partners; outside such scope the state acts on its authoritative, administrative-law basis.

Joint venture agreements

The joint venture is another most common and effective means of conducting business internationally.[137] There are many areas, in which the state is able carry out joint activities with foreign legal persons such as the geological research and exploratory work, assembly and construction, servicing plant and machinery, and so on. Joint ventures also become common in the mineral development sector, like Saudi Aramco in Saudi Arabia and Erdenet mining company in Mongolia. Whatever the type of the joint venture activity, the model allows the sovereign or its entity to get directly involved in the development of the project.[138]

The state participation in the joint business arrangement structurally can take many forms and its structure and the form of operation may vary from one country to another country.[139] In Australia for example, forms of joint ventures can classified as follows:[140]

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[137] In a typical joint venture agreement, two or more existing businesses agree to co-operate and combine their resources and efforts to further their business goals. It is suitable where the parties wish to come together for a specific project for a specific length of time but do not wish to be bound together indefinitely. However, there is no precise definition of a joint venture and the term encompasses a variety of modes of co-operation. For a discussion on joint ventures see Stephen King, 'Short of a Merger: the Competitive Effects of Horizontal Joint Ventures' 1998) 6 *Competition and Consumer Law Journal* 227.

[138] It has been indicated that the state participation is intended to "phase out" the foreign investor and take over in the specific economic activity. See H S Zakhariya, 'State Petroleum Companies' (1978) 12 *Journal of World Trade* 481.

[139] In the Draft of International Financial Reporting Standard issued by International Accounting Standards Board (IASB) joint arrangements are classified into three basic forms- joint operations, joint assets and joint ventures. See International Accounting Standards Board (IASB), *ED 9 Joint Arrangements,* Draft of International Financial Reporting Standard (IFRS) (2007) 12-14.

[140] Peter Doyle, Tony Holland and John Naughton, 'Project and Infrastructure Financing' in David Allan et al, *Australian Finance Law* (2003) 291-292.

- Incorporated Joint Ventures - they involve the establishment of a separate legal entity, such as a corporation. The constituent documents of the company usually set out the entitlement of the parties to seats on boards, voting rights at both board and shareholder levels, powers of the board, quorums of meetings of directors and shareholders, rights of pre-emption and options over shares and so on. The advantage of this form is that as shareholder, a project sponsor is personally not responsible for the activities of the joint venture unless it is the holding company of the joint venture or it is aware of the insolvency of the joint venture.
- Partnerships - partnerships have been commonly used for projects in energy, for property developments, and for toll road projects. The partners owe fiduciary obligations to each other and each of them has no title to specific partnership assets. Partnerships are a "pass through" entities for income tax purposes meaning that the taxes are assessed at the entity level, but the profits or losses flow through the partnership to the partners and they have to pay tax on their share.
- Unincorporated Joint ventures - this form of a joint venture does not require the establishment of a separate company. The joint venture agreement defines the activities of the joint venture. The parties hold joint venture assets as tenants in common and deal with them only as provided in the agreement. Each sponsor is liable for their proportionate share of costs and expenses of the joint venture.
- Unit Trust - Unit trusts are occasionally used form of collective investment. In the unit trust, the beneficial interest in the trust property is divided into units which may be dealt with by the owners of those units. The unit holders are not responsible for the activities of the trust. The disadvantage of the unit trusts is their taxation is very complex.

In the business cooperation with a foreign private party, a state may act itself or participate through its organs, agencies and even state entities. The legal implications of the state party's presence may vary depending on whether the state is a direct contract partner or if this role is assumed by its enterprise. In relations of the first type, a state is a subject of international law with all corresponding prerogatives, while in relations a state enterprise is a corporation created by the state and usually governed the state's public law.[141] A state enterprise thus possesses a separate legal identity that may allow it to independently operate in a commercial plane. But

[141] Peter Wolfgang, *Arbitration and Renegotiation of International Investment Agreements* (1986) 28.

because such state entities are usually the consequences of economic and social policies of the host state, it could not be entirely separate from the state. The state can even liquidate the entity if changed circumstances require such a course of action.

Nowadays, the use of state enterprises in the foreign investment sector has become a common practice not just in developing countries, but also in the Western world. Particularly, Britain and Norway have established state enterprises for North Sea oil exploitation.[142] Statoil is operator for 24 oil and gas fields in Norwegian continental shelf and accounts for 60% of all Norwegian petroleum production.[143] Thus, one of the special features of the joint venture agreements is that developed states also can be a host state in these contracts.

Another important feature of joint ventures is that in majority of states, a joint venture is regarded as a juridical person of the country where it is established. For instance, *Foreign Investment Law* of Mongolia[144] states:

> "A business entity with foreign investment shall become a legal person of Mongolia from the date of its registration and shall conduct its operations in accordance with the laws of Mongolia."

The rule is in conformity with the incorporation theory that is favoured in the world practice. Under the theory, an incorporated entity is regarded a legal person of the country, where it is formed.[145] The rule would exclude a large proportion of foreign investment of international protection. In order to avoid this undesirable result, international investment arbitrations have resorted to a variety of methods.[146]

Furthermore, the host country may impose additional requirements on foreign investors establishing a joint venture within the country. In particular, Australia has a long tradition to

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[142] Ibid.

[143] Statoil, History (2006) < www.statoil.com > at 22 December 2006.

[144] Art 11 (2).

[145] See *Barcelona Traction (Belgium v Spain)* [1970] ICJ Rep 3.

[146] See the discussions on the theory of incorporation in Ch 5, Subsection 5.2.2 (Customary International Law).

restrict the foreign participation in the national interest sector such as mining and production of uranium.[147] Under the *Foreign Acquisitions and Takeovers Act 1975*, it is compulsory for a foreign investor to acquire a substantial shareholding of an Australian corporation unless the total assets are below the $50 million threshold established under the *Foreign Acquisitions and Takeovers Regulations 1989*.[148]

The basic provisions relating to joint enterprises are usually contained in the relevant law. The establishment of a joint venture requires not only the share of a local party in the basic fund of the enterprise, but also other obligations such as employment and the meeting of health and environmental standards. The entity is also subject to the public policy of the host state regarding export and import licenses for equipment and products, taxation, production requirements. At the same time, it enjoys equal rights and interests with local enterprises such as the power to conclude contracts, acquire property and personal non-property rights, incur liability, and sue and be sued in a court of law or arbitration.[149]

Other types of state contracts

The demands of contemporary complex society have led to the vast expansion of the state's functions. One of the main actions of today's government is to promote economic and social development of the country to provide healthier and happier lives for people. To deliver such fundamental public goods as property rights, roads, and basic health and education, the government cooperates with citizens and communities, thereby taking the burden off the state.

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[147] Until 1979, when the amendment was made to Guidelines for Australian participation in the natural resources sectors, a proposed project for the mining and uranium development would only be allowed to proceed if it has a 75 per cent Australian entity and was Australian controlled. David Flint, *Foreign Investment Law in Australia* (1985) 102.

[148] *Foreign Acquisitions and Takeovers Act 1975*, Art 26.

[149] For example, the Chinese law states: "The state shall, according to law, protect the lawful rights and interests of the contractual joint ventures and of the Chinese and foreign parties. A contractual joint venture must abide by Chinese laws and regulations and must not injure the public interests of China. The relevant state authorities shall exercise supervision over the contractual joint ventures according to law. *Sino-Foreign Contractual Joint Venture Law* (1998) Art 3.

This has meant that a state enters into the most diverse types of commercial contracts with individual citizens.

In recent years, the use of public-private partnerships (PPPs) has become a popular method of delivering needed infrastructure or services. It involves the use of the private sector in the construction and funding of public infrastructure work. Some countries, like the UK and Australia have been implementing PPPs for many years, when many other countries particularly, former socialist countries in Central Europe currently began experimenting PPPs in their infrastructure projects.[150] There are a number of reasons that support the PPP initiative in the transition countries, but the key ones include maximising value for money, reducing public debt and strengthening infrastructure.[151]

Approaches to the regulation of infrastructure and services may vary from one jurisdiction to another depending on a sector or a country practice.[152] There seems to be three levels of regulation for infrastructure projects. In some countries, the law merely refers to the need for an infrastructure project agreement, while other countries have extensive mandatory provisions that apply for the agreement. An intermediate approach is taken by some jurisdictions which list only the issues that should be addressed without regulating in detail the content of the agreement.[153]

The fact that such projects usually involve a significant number of parties including the sponsors, lenders, borrows, insurance companies and host governments and a network of various interrelated agreements between them makes the legal nature of these agreements very

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[150] Peter Snelson, 'Public-Private Partnerships in Transition Countries' in European Bank for Reconstruction and Development, *Law in Transition* 2007, 30.

[151] Ibid, 32-33.

[152] There have been adopted various non-binding guidelines and principles to assist legislative drafters in adopting a legal framework that deals with privately financed infrastructure projects. See, eg, UNCITRAL*, UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects* (2001) and OECD, *OECD Principles for Private Sector Participation in Infrastructure* (2007).

[153] UNCITRAL above n 152, 103.

complex.[154] As Dugue observed, multi-party disputes could arise between the multiple parties to a single agreement containing a single choice of forum clause or, more problematically, between different parties to different multi-party agreements containing different choice of forum clauses.[155] Also the unique technical nature of those contracts, which depends on whether the project is assembly and construction of roads and infrastructure or servicing of plant and machinery or public electricity, may require a specific rule rather than a generalised conception. Furthermore, the risk is magnified when one considers the public importance of many of these projects, because infrastructure projects deliver important public services such as water, electricity, telecommunications, or transportation which normally can be politically sensitive.[156]

A quite new and advanced sphere of cooperation is technology transfer agreements for the use of inventions and other scientific and technical achievements (know-how). Unlike other forms of contract, the technology transfer agreements are subject to international treaties rather than local laws. Apart from the old convention on industrial property rights,[157] many treaties adopted by WIPO and WTO have extended the scope of protection accorded to technology owners.[158] On the contrary, UNCTAD has sought to control the conditions which technology is transferred working on the *Draft Code of Conduct on Transfer of Technology*. [159]

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[154] In this contract, the state's duty is to grant the sponsor the "concession" - that is the right to build, own and operate the facility. Other parties to the contract are a sponsor who finances the particular project, a constructor who is responsible for the completion of the project, an operator who signs a long term contract with the sponsor for the operation and the maintenance of the facility, financiers who provide the debt funds to the sponsor as well as equity investors, insurers, suppliers, engineering and design consultants.

[155] Christopher Dugue, 'Dispute Resolution in International Project Finance Transactions' (2001) 24 *Fordham International Law Journal* 1064, 1076.

[156] Nagla Nassar, 'Project Finance, Public Utilities and Public Concerns: A Practitioner's Perspective' (2000) 23 *Fordham International Law Journal* 60, 65.

[157] *International Convention for the Protection of Industrial Property,* opened for signature 20 March 1883, [1907] ATS 6 (entered into force 6 July 1884) *('Paris Convention').*

[158] Now, 24 treaties have been administered by the WIPO such as *Patent Law Treaty* (2000) and *Singapore Treaty on the Law of Trade Marks* (2006), while WTO has adopted one treaty in this field - *Trade Related Intellectual Property Rights* (TRIPS).

[159] UNCTAD, *Transfer of Technology* (2001) < http://www.unctad.org/en/docs/pciteilitd28en.pdf > at 21 January 2006.

Lastly, international investment also can be made in the form of a loan. However, when the investment takes a form of loan, stipulations as to choice of law of some State other than the host State are common.[160] In practice, the law of the State from which a loan issues is commonly adopted rather than the law of the borrowing State.[161] Conventional conflict rules are still applicable to such contracts because "traditional loan contract more closely resembles the traditional kind of contract than it does the complex direct investment agreement".[162]

2.2. Changing Characteristics of Foreign Investment Contracts

Foreign investment contracts have played a major role in the economic development process, especially in developing countries that are dependent upon the exploitation of natural resources for their economic welfare. As such, they represent an important tool of development policy. Without the use of such contracts significant opportunities for the development of strategic national industries may well have been lost. The theory of internationalisation of state contracts, however, has attempted to insulate the contracts from the effects of national controls. As a result, current rules of international law have done little to address the developmental needs of developing states.[163] But the rules of international law primarily concerned with the investment protection are changing in the light of the evolution of international development law. Attention must be paid to these transformations.

2.2.1. THE CONNECTION BETWEEN FOREIGN INVESTMENT AND ECONOMIC DEVELOPMENT

Foreign investment does not automatically boost economic growth. The role of law is unarguable in promoting sustainable economic growth. Studies have shown that the reduced

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[160] Khan, above n 106, 13.

[161] Georges Delaume, *Legal Aspects of International Lending and Economic Development Financing* (1967) 71.

[162] Khan, above n 106, 13.

[163] Maniruzzman, above n 106, 44.

control over the activities of the foreign investment not only reduces the potential benefits of the foreign investment but also may bring harm especially to the environment.[164] The Bhopal disaster in India, in 1984 killing thousands of innocent people, is an indication of how expanding foreign investment in developing countries without enforceable international standards for corporate social responsibility could have catastrophic consequences.

In the 1970s, under the pressures especially from developing states and non-governmental organisations, the UN General Assembly adopted various sets of resolutions aimed at the correction of contractual imbalances and the restoration of developing states' capacity to oversee the evolution of the resulting relationship in a manner consistent with national development policies. Although the norms of the General Assembly resolutions such as the doctrine of permanent sovereignty over natural resources,[165] the establishment of a new economic order,[166] economic rights and duties of states[167] may not have binding force, they arguably have contributed a lot to the evolution of new values and standards reflecting the relevance of foreign investment to economic development.

These new developments also have affected the attitudes of international investment arbitrations to the foreign investment contracts. It was first recognised in the *Aminoil Arbitration*[168] that evolutions taking place within in foreign economic sector in the light of global

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[164] See Dani Rodrick, *The False Promise of Financial Liberalization* (2007) Global Policy Forum <http://globalpolicy.igc.org/globaliz/econ/2007/0122falsepromise.htm> at 24 August 2007. Also, Mabey and McNally argue that the removal of barriers to trade and capital mobility through international treaties has lead to a substantial increase in environmental damage in developing economies. Nick Mabey and Richard McNally, *Foreign Direct Investment and the Environment: from Pollution Havens to Sustainable Development* (WWF-UK, Research paper, November 1999).

[165] *Permanent Sovereignty over Natural Resources,* GA Res 1803 (XVII), UN GAOR, 17th secc, 1194th plen mtg, UN Doc A/Res/1803 (XVII) (1962).

[166] *Declaration on the Establishment of a New International Economic Order,* GA Res 3201 (S-VI), UN GAOR, 6th secc, 2229th plen mtg, UN Doc A/Res/3201 (S-VI) (1974).

[167] *Charter of Economic Rights and Duties of States,* GA Res 3281 (XXIX), UN GAOR, 29th secc, UN Doc A/Res/3281 (XXIX) (1974).

[168] *American Independent Oil Company v Government of Kuwait* 21 ILM 976 (1982) *('Aminoil Award').*

events could change the structure of the contract. The tribunal emphasized this new character as follows:

> "The concession in its origin a mining concession granted by states whose institutions were still incomplete and directed to narrow patrimonial ends became one of the essential instruments in the economic and social progress of a national community in the full process of development. This transformation, progressively achieved, took place at first by means of successive increases in the financial levies going to the state, and then through the growing influence of the state in the economic and technical management of the undertaking, particularly as to the control of pricing policy, taken over in 1973, and the regulation of works and investment programs. The contract of concession thus changed its character and became one of those contracts in the regard to which, in most legal systems, the state, while bound to respect the contractual equilibrium, enjoys special advantages." [169]

Not surprisingly, it is now well established that the economic impact of benefits of foreign investment contracts is one of the decisive criteria that determine whether an activity of a foreign citizen could be considered as investment and thus could be afforded investment protection under international law. In many recent arbitral awards of ICSID, it was emphasized that the project must represent a significant contribution to the host state development to qualify as an investment.[170] For instance, in one award of the ICSID tribunal, where it discussed the matter whether there was a economic contribution to Malaysia's economic development, the tribunal found that "the Contract did not benefit the Malaysian public interest in a material way or serve to benefit the Malaysian economy in the sense developed by ICSID jurisprudence,

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[169] Ibid, para 98.

[170] *Bayindir Insaat Turism Ticaret Ve Sanyi AS v Islamic Republic of Pakistan* (Decision on Jurisdiction) (14 November 2005) <http://ita.law.uvic.ca/documents/Bayindr-jurisdiction.pdf > at 22 December 2007; *Joy Mining Machinery Ltd v* Arab Republic of *Egypt* (Award on Jurisdiction) (6 August 2004), 44 ILM 73 (2005); *Salini Construttori SpA v Hashemite kingdom of Jordan* (Decision on Jurisdiction) (9 November 2004), 44 ILM 573 (2005).

namely that the contributions were significant."[171] Accordingly, the tribunal concluded that it had no jurisdiction over this dispute and dismissed the claims made by the claimant.

Thus, there is evident transformation from earlier types of internationalized concession agreements that were biased in investors' favour to the newer types of agreements balancing the needs of economic development of the host state with legitimate commercial expectations of the foreign investor. In the light of these new developments, the approaches developed in the context of the theory of internationalisation are no longer suitable. In particular, stabilisation clauses, choice of external law, and internationalised arbitration clauses began to be seen as inconsistent with the aims of host country development policies and with the right to regulate major investment projects.

It is also worth noting that foreign investment agreements have been renamed as economic development agreements (hereinafter EDAs), a name that intrinsically reflects the understanding that such agreements are designed to promote the economic and social development of a host state, thus they should be subject to the host state's legal rules motivated with developmental objective. In other words, foreign investment contracts are not just a mere type of state contract made between a state or a state entity and a foreign national or a legal person of foreign nationality, rather it must satisfy certain criteria to be accepted as foreign investment contract enforceable under international law.

Definition of Foreign Investment Contract

In practice, the issue whether the contract concerned qualifies characteristics of foreign investment contracts pretty much depends on the scope of definition of investment provided for in an international agreement. The investment protection measures provided in the international agreements apply only to investors whose investments qualify for coverage under the relevant

[171] *Malaysian Historical Salvors Sdn, Bhd v The Government of Malaysia* (Decision on Jurisdiction) (17 May 2007), para 131 <http://ita.law.uvic.ca/documents/MHS-jurisdiction.pdf > at 23 November 2007.

provisions. As a result, investor/state arbitral tribunals institutional or *ad hoc* alike have to consider whether there is an investment under the relevant investment agreement before accepting jurisdiction.

But the problem is that no commonly accepted definition of investment exists. Even the ICSID Convention[172] as being only international instrument which offers permanent institutional system of dispute settlement in this field itself did not define the term "investment". Article 25(1) provides that "the jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment between a Contracting State . . . and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre."[173] So far, the approach adopted in the Convention gives parties to ICSID arbitration wide discretion to describe a particular transaction as investment.

Besides, most modern multilateral and bilateral investment treaties and trade agreements tend to define "investment" in the broadest possible terms to achieve the treaties' purpose of regulating all investments, regardless of the form in which they are made or the name by which they are called. They usually refer to every kind of assets followed by an indicative but not limitative list of covered assets. They even provide a protection for contract-based rights attempting to subject the withdrawal of administrative licenses to treaty provisions.

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[172] An account of these negotiations given by Broches is pertinent:

> "During the negotiations, several definitions of investment were considered and rejected. It was felt in the end that a definition could be dispensed with given the essential requirement of consent by the parties. This indicates that the requirement that the dispute must have arisen out of an 'investment' may be merged into the requirement of consent to jurisdiction. Presumably, the parties' agreement that a dispute is an 'investment dispute' will be given great weight in any determination of the Center's jurisdiction, although it would not be controlling." Aron Broches 'The Convention on the Settlement of Investment Disputes: Some Observations on Jurisdiction' (1966) 5 *Columbia Journal of Transnational Law* 261, 268.

[173] *Convention on the Settlement of Investment Disputes between States and Nationals of Other States,* opened for signature 18 March 1965, 575 UNTS 159 (entered into force 14 October 1966) [hereinafter *ICSID Convention*]

Specifically, *NAFTA*[174] defines investment very broadly covering almost all types of ownership interests. Investments under the *NAFTA* include enterprises, equity and debt securities, loans, income and profits, real estate or other property, tangible or intangible and contracts including turnkey or construction contracts, or concessions. It only excludes commercial contracts for the sale of goods or services (procurement contracts) as being considered investments. The NAFTA approach has been followed in many free trade agreements.[175] The *1994 Energy Charter Treaty*,[176] in Article 1(6) (f), defines investment to include "any right conferred by law or contract or by virtue of any licenses and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector".

Thus, it is evident that the modern treaties pursued a broad objective of internationalisation of foreign investment contracts going further than earlier bilateral investment treaties which adopted a restrictive approach to the investments that enjoyed protection under the treaty. Under these earlier bilateral investment treaties, the form and type of investment was at the discretion of the host state authorities, and the treaties often affirmed that this was a matter left to local law and regulations.[177] For instance, Article 9 of the 1972 *Belgium/Luxembourg-Indonesia BIT* notes that the treaty covers only those investments made into Indonesia that have been approved pursuant to Indonesia's *Foreign Investment Law* or its other relevant laws.

In ICSID practice, disputes submitted to the arbitration tribunal must qualify for coverage not only under the bilateral or multilateral investment treaty, but also must meet

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[174] *North American Free Trade Agreement between the Government of Canada, the Government of the United Mexican States and the Government of the United States of America*, opened for signature 17 December 1992, 32 ILM 296 (1993), Art 1139 (entered into force 1 January 1994) [hereinafter *NAFTA*].

[175] See, eg, FTAs recently negotiated between the US and Australia, Singapore and Chile, the Republic of Korea and Chile respectively (chapter on investment).

[176] *Energy Charter Treaty*, opened for signature 17 December 1994, 33 ILM 360 (entered into force 16 April 1998) [hereinafter *ECT*].

[177] UNDP, *Investment Provisions in Free Trade Agreements and Investment Treaties* (2005) UNDP Regional Centre in Columbia <http://www.undprcc.lk/Publications/Publications/BIT-completed.pdf > at 24 February 2008.

characteristics of investment for *ICSID Convention* purposes. In the tribunal's view, the term investment should be interpreted in light of the Preamble of the *ICSID Convention* so that the contributions result in some form of positive economic development for the host State.[178]

In order to determine the correct approach to the meaning of investment, the tribunal in *Malaysian Historical Salvors Sdn, Bhd v Malaysia* examined previous seven cases where the notion of investment was discussed.[179] On the legal analysis of the relevant authorities, the tribunal identified the following elements as characteristics of an investment: i) regularity of profits and returns; ii) contributions in money, in kind and in industry; iii) the duration of the contract; iv) the risks assumed under the contract and v) contribution to the economic development of the host State. According to these criteria, a foreign investment contract can be defined as a type of a state contract entered into between a public agency and a foreign corporation or private individual for execution of a public development project which involves a considerable degree of risks and is expected to be performed over a long period of time.

As the attitudes to foreign investment contracts began to change, they ceased to be mere commercial contracts. In this respect, the public law features of these contracts have been revived. The motivation for the concluding foreign investment agreements by host states is its economic development and welfare of its people. As a general rule, if there is a public interest in a given subject and the need for a regulatory perspective on this subject, then it is the subject matter of public law. It is not denying that many disputes between governments and foreign private parties involve issues such as expropriation, environmental protection, taxation and labor rights which traditionally fall in the orbit of public law.

2.2.2. NEW PRINCIPLES APPLICABLE TO FOREIGN INVESTMENT CONTRACTS

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[178] *Malaysian Historical Salvors Sdn, Bhd v The Government of Malaysia* (Decision on Jurisdiction) (17 May 2007), paras 66-68 <http://ita.law.uvic.ca/documents/MHS-jurisdiction.pdf > at 23 November 2007.

[179] Ibid, paras 73-104.

As the characteristics of foreign investment agreements have undergone substantial changes over the years, new principles that reflect the fundamental shift are likely to emerge. But it should be noted the principles emerging in the foreign investment sector are not new in the legal sense. Most of them are known to major domestic legal systems. Indeed, these principles have been largely dispensed by investment arbitrations as they were inconsistent with the perspectives of internationalising the applicable law.

Principle 1: Recognition of sovereign control over its economy

In the context of the theory of internationalisation of state contracts, the advocates of the theory have attempted to curtail sovereign legislative powers of the host state to change the legal environment of foreign investment. In this regard, various steps have been taken such as the inclusion of stabilization clauses into the contract between a state and a foreign investor and the elevation of foreign investment contracts to a treaty level. But none of such efforts has succeeded.

Nonetheless, current practice has moved towards recognising sovereign power to control its economy. Several ICSID decisions on expropriation rendered in the early 2000s have shown that the right of expropriation of the host state has returned in international law.[180] The current view is that not every taking or measure does necessarily constitute expropriation. Dealing with a case of indirect expropriation, arbitrators thus, have to draw a line between expropriation and a valid governmental activity.

In *Feldman v Mexico,* for example the tribunal held that:

> "First, the Tribunal is aware that not every business problem experienced by a foreign investor is an indirect or creeping expropriation under Article 1110…, not all

[180] *Marvin Roy Feldman Karpa v United Mexican States* (16 December 2002), 42 ILM 625 (2003); *Tecnicas Medioambientales Tecmed SA v United Mexican States* (Award) (29 May 2003), 43 ILM 133 (2004); *LG&E Energy Co, LG&E Capital Co and LG&E International Inc v Argentine Republic* (Decision on Liability) (3 October 2006), 46 ILM 36 (2007); *EnCana Co v Republic of Ecuador* (Award) (3 February 2006) UNCITRAL, LCIA Case No UN3481 <http://ita.law.uvic.ca/documents/EncanaAwardEnglish.pdf > at 21 July 2007.

> government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation under Article 1110. Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue. "[181]

In another case, even though the tribunal found that the measures adopted by Argentina resulted in a violation of the rights guaranteed under the Treaty to foreign investments, it held that it was necessary for Argentina to enact such measures to maintain public order and protect its essential security interests. Thus, the tribunal absolved Argentina from liability for losses caused during the period of necessity.[182]

Principle 2: Re-negotiability of contract terms in the light of economic changes

One of the important features of an economic development agreement is its long term nature. Especially in the natural resources sector, the duration of the contract term is much longer ranging from 20 to 50 years. So, it must be expected that ecological, regulatory, commercial and political risks may occur during such a long period of time. Such risks can affect the operation of the contract making it impracticable or, from a commercial and financial perspective, no longer viable for one party.

As a result, international contracting practices in investment sector have recognised the necessity of some sort of adaptation mechanism to facilitate the smooth functioning of a long-term business relationship in the event of fundamental change in circumstances. In that change of circumstances, renegotiation becomes for both parties a way to maintain the benefits of the contractual relationship by adapting the contractual document to new external circumstances.

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[181] *Marvin Roy Feldman Karpa v United Mexican States* (16 December 2002), 42 ILM 625 (2003), para 112.

[182] *LG&E Energy Co, LG&E Capital Co and LG&E International Inc v Argentine Republic* (Decision on Liability) (3 October 2006), 46 ILM 36 (2007), para 226.

Therefore, it is now not unusual for parties to international investment agreements in the petroleum and mineral sector to include general "cooperation" or "review" clauses by which the parties promise to review the satisfactory operation of the agreement from time to time. [183]

Indeed, most legal systems recognise the issue of contract renegotiation in a long-term commercial contract when, due to an unforeseen drastic change in circumstances the continuation of on-going performances under the contract has became extremely onerous to one party.[184] The legal basis of such action is the principle of *rebus sic stantibus*. The doctrine, however, was denied by international investment arbitral tribunals advocating the internationalist approach. In the *Aminoil award* for instance, even though the tribunal accepted the idea that there could be change in the nature of the contract itself, it did not recognise the applicability of the doctrine *rebus sic stantibus*. [185]

However, recent decisions of arbitral tribunals have shown that there are changes to this legal framework. What is more important is international arbitral tribunals of investment disputes have acknowledged that economic changes which may affect the equilibrium of long-term contracts are unavoidable. Particularly, in a recent award, it was noted that "No investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged."[186]

The renegotiation practice in international petroleum industry thus suggests that the principle of change of circumstance should apply to long-term petroleum investment agreements. In other words, the private law versions of the general principle of *"rebus sic stantibus"*

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[183] Waelde and Kolo reviewed some of the major renegotiation cases which have taken place in the petroleum and mining industries since the 1960s. Thomas Wälde and Abba Kolo, 'Renegotiation and Contract Adaptation in the International Investment Projects: Applicable Legal Principles and Industry Practices' (2000) 1 (1) *Journal of World Investment* 5.

[184] Ibid.

[185] See *Aminoil Award* 21 ILM 976 (1982), para 98.

[186] *Saluka Investments BV v The Czech Republic* (Partial Award) (17 March 2006) UNCITRAL Arbitration, para 305 <http://ita.law.uvic.ca/documents/Saluka-PartialawardFinal.pdf > at 21 December 2007.

such as American *commercial impracticability*, the English *frustration of purpose*, the German *Wegfall der Geschäftsgrundlage* and the French *imprévision* are to be accepted in international arbitral awards. Then, that would raise conflict over the stability and flexibility of a long-term investment agreement shaking the principles to which opponents of the theory of internationalisation of state contracts so adhere such as sanctity of contracts and stabilisation clauses.

Principle 3: Duty to invest with adequate knowledge of risk

Many recent cases of ICSID arbitration accepted that the investor is bound to assess the extent of the investment risk before entering the investment and to have realistic expectations as to its profitability because of various risks involved in the operation of the contract. In particular, in the *Telenor Mobile Communications* case the tribunal noted:

> "Any investor entering into a concession agreement must be aware that investment involves risks and that in some degree the investor's activities are likely to be regulated and payments made for which the investor will not receive compensating advantages. These are all part of the price the investor has to pay for securing the concession."[187]

In another award, *Maffezini v Spain,* the tribunal also emphasized that "Bilateral Investment Treaties are not an insurance policies against bad business judgments."[188] Besides, risks assumed under investment contracts are now one of essential characteristics of investment under ICSID jurisprudence.[189]

The duty to invest with adequate knowledge of risks is consistent with good business practice, as it requires the investor to take responsibility for the normal commercial risk associated with the investment rather than to seek a source of relief under the applicable

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[187] *Telenor Mobile Communications AS v Republic of Hungary* (Award) (13 September 2006), para 64 <http://ita.law.uvic.ca/documents/TelenorvHungaryAward_001.pdf > at 21 December 2007.

[188] *Emilio Augustín Maffezini v Kingdom of Spain* (Decision on Jurisdiction) (25 January 2000), 40 ILM 1129 (2001), para 64.

[189] See, eg, *Salini Construtorri SpA and Italstrade SpA v Morocco* (Decision on Jurisdiction) (23 July 2001), 42 ILM 609 (2003); *Bayindir Insaat Turism Ticaret Ve Sanyi AS v Islamic Republic of Pakistan* (Decision on Jurisdiction) (14 November 2005) <http://ita.law.uvic.ca/documents/Bayindr-jurisdiction.pdf > 22 December 2007; *Malaysian Historical Salvors Sdn, Bhd v The Government of Malaysia* (Decision on Jurisdiction) (17 May 2007), paras 66-68 <http://ita.law.uvic.ca/documents/MHS-jurisdiction.pdf > at 23 November 2007.

investment agreement.[190] When drafting their contract thus, parties to a foreign investment contract should discuss management of risk as one of the keys to achieve for beneficial outcome of the contract.

Principle 4: Compliance of related regulations of a host state by foreign investors

One of the specific characteristics of foreign investment contracts is that the government party has a powerful opportunity to impose its own conditions and terms of the contract on the private party. In general, most countries, developed and developing ones alike have adopted codes or laws to establish a regime that provides an extensive and comprehensive regulation of investments, on both the substantive and procedural levels.[191] Foreign investors entering the host state have to meet conditions laid down by these laws, and obey other regulatory measures.

The legal basis of the principle requiring foreign investors to comply with legal requirements lies primarily on the inherent international legal right of the sovereign state to control conduct that occurs upon its territory. Such a right of the host state is also supported by the concept of permanent sovereignty over natural resources, some BITs as well as Codes of Conduct for Transnational Corporations. Particularly, the 1990 Draft Code, TNCs imposes on multinationals broad duties relating to ownership and control, compliance with national economic and developmental objectives, restrictive business practices, taxation, and transfer pricing.[192] On the other hand, the case law also reaffirms the duty of multinationals to accept and abide by the laws of the host state. For instance, the final award rendered on 2 August 2006 in

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[190] Peter Muchlinski, 'Caveat Investor? The Relevance of the Conduct of the Investor under the Fair and Equitable Treatment Standard' (2006) 55 (3) *International and Comparative Law Quarterly* 527, 542.

[191] Just to mention two which are *Cameroonian Public Contracts Code* instituted by Decree No 2004/275 of September 2004 and the US *Federal Acquisition Regulation* (FAR) 2005-23.

[192] *Code of Proposed Text of the Draft Conduct on Transnational Corporations,* UN ECOSOC, 2nd sess, Annex, UN Doc E/1990/94 (1990) ss 14, 21–34 [hereinafter *UN Draft Code of Conduct*].

the *Inceysa Vallisoletana* case, the tribunal accepted investments complying with local law as a precondition to benefiting from that treaty's protection.[193]

Principle 4: Transparency of proceedings involving a state or a state agency

The recent case law as well as international instruments on the arbitral proceedings appears to be developing a principle that the public is allowed to access to arbitral proceedings relating to government and public matters. In *Loewen v USA,* the tribunal did not accept the claimant's position that each party was under a general duty of confidentiality in regard to the proceeding. The tribunal held that a general duty of confidentiality in arbitration to which a government was a party would be undesirable, as it would prevent a government (or the other party) from discussing the case in public "thereby depriving the public of knowledge and information concerning government and public affairs."[194] Some recent FTAs also provide for transparency of proceedings that hearings can be open to the public, and submissions and documents exchanged in the arbitration shall be made public, save for particularly protected confidential information.[195]

2.3. Summary of Findings

This chapter has a key role in the overall arguments of this thesis. It sought to establish the position of state contracts in the domain of international law by investigating modern trends in the internationalisation theory. The chapter recognised that the principles and authorities that

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[193] *Inceysa Vallisoletana SL v Republic of El Salvador* (Award) (2 August 2006), para 207 <http://ita.law.uvic.ca/documents/Inceysa_Vallisoletana_en_001.pdf > at 20 December 2007.

[194] *Loewen Group Inc and Raymond L Loewen v United States of America* (Decision on Jurisdiction) (5 January 2001), 7 ICSID Rep 421, para 26.

[195] See, eg, *US-Singapore FTA,* Arts 15.20 (transparency) and 4.6 (confidentiality) http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Singapore_FTA/Final_Texts/asset_upload_file708_4036.pdf or *US-Chile FTA,* Art22.10(1) <http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Chile_FTA/Final_Texts/asset_upload_file683_4016.pdf > at 28 July 2007.

support the internationalist approach to state contracts have been weakened in the light of the emerging principles.

Initially, under the theory of internationalisation of state contracts, a foreign investment contract concluded between a host state and a foreign national was regarded as nothing more than an ordinary commercial contract. Arbitrators dealing with disputes between host states and foreign investors thus predominantly utilised commercial law principles that protect private rights. Now, the "investor-protectionist" approach of earlier investor/state arbitral tribunals has been gradually eroded by other concepts which have emerged in the light of a broader context - that is the concern of economic development.

These new concepts that have received vigorous assertion through a series of resolutions of the GA establishing the right of developing states to control their economies have raised certain demands on the part of foreign investors, such as to invest for the benefit of the host economy and community. Many recent cases of ICSID arbitration reveal the adoption of certain new principles and standards that may lead to changes in current approaches or resolve current conflicts arising from the theory of internationalization. From the investigation of the recent ICSID case-law, five major principles are identified. These are as follows: recognition of sovereign control over its economy, re-negotiability of contract terms in the light of economic changes, duty to invest with adequate knowledge of risk, compliance of relevant regulations of a host state by foreign investors and transparency of proceedings involving a state or a state agency.

On the basis of the discussions, one may say that changes in approaches of international investment arbitration are an indication that the arbitrators now moving away from their early straightforward framework designed to protect foreign investment in a new direction of the host state's economic development. This shift may result in the acceptance of other principles which

recognise public law features of state/individual contractual relationship such as the *contrat administratif* of the French law.

Over four decades ago Friedmann suggested that the French theory could provide "a solution that is theoretically proper and practically fair".[196] This may remain valid so far. International investment arbitrators recognizing the distinctive nature of foreign investment contracts should develop and elaborate a legal atmosphere which can guarantee the equilibrium where the needs of economic development of the host state are balanced with the legitimate protection of the investor.

[196] Wolfgang Friedmann, *The Changing Structure of International Law* (1965) 200-206.

Part Three: A HISTORICAL AND THEORETICAL OVERVIEW OF CHOICE OF LAW ISSUE IN STATE CONTRACTS

Any discussion of the history of choice of law in state contracts must start at the emergence of the theory of internationalisation in the mid 1950s. Before this time, according to the classical doctrine, traditional concession contracts, which are the "ancestors" of modern foreign investment contracts, were always subject to the municipal law of the host state. It is not surprising therefore that there was no discussion of choice of law rules in the context of concession contracts.

However, international arbitral tribunals of 1950s broke with the long standing tradition by elaborating the theory of internationalisation of state contracts. According to this theory, parties to foreign investment contracts are able to choose public international law as the law applicable to their contract. That was the beginning of the development of choice of law rules in state contracts.

The application of international law to these agreements faced a number of theoretical and practical obstacles which confront such application, while the choice of law rules developed in the context of theory of internationalisation violated traditional rules of private international law. The objective of this part of the thesis is to discuss the historical and theoretical issues concerning the application of international law to investment contracts.

Beginning with discussions on the historical reasons for choosing an external system as the law applicable to concession contracts, *Chapter Three* examines the validity of foundations of the internationalisation theory. It points out that, initially, international law on foreign investment had a single objective - to provide protection for investors. It examines the early arbitral cases that gave birth to the theory. The next section of *Chapter Three* analyses the propositions advanced by the early arbitral tribunals of investment disputes to reinforce the claim for applying

a-national rules to investment agreements. It is argued that these propositions were very doubtful. Some of them were inconsistent with prevailing juristic theories or not applicable to this kind of relationship, while other norms were too weak to be accepted as valid.

Chapter Four concentrates on controversies surrounding the theory of internationalisation while reviewing theoretical and empirical studies. The application of international law to state contracts as a methodology for resolving choice of law issues posed many serious theoretical controversies that relate to both public and private international law. In the first section of this chapter, it is argued that the adoption of this theory was intolerable from all angles of customary international law. First, the theory would put foreign companies on an equal footing with states, before the question of the international legal status of commercial companies had been effectively resolved. Then, legal uncertainty had arisen as to how public international law, that had developed no rules in relation to the state-alien relationship, except for the principle of diplomatic protection, could regulate a contractual relationship. Furthermore, the longstanding concept of legal positivism was also shaken, as the arbitral tribunals arguing for this theory had taken up a monist version of the relationship between international law and national law. The next section of *Chapter Four* deals with the controversies relating to private international law. It points out that much confusion arose because of efforts of the arbitral tribunals to coalesce two branches of law, ie public and private law in single context. It also shows that the internationalisation theory had deviated from the tradition of the principle of party autonomy.

CHAPTER THREE: EVOLUTION OF THE THEORY OF INTERNATIONALISATION AS CHOICE OF LAW RULE

3.1. The Historical Background

The development of choice of law rules in contracts between a State and a foreign private party is a relatively recent phenomenon in the history of private international law. At an earlier stage, there was a tradition of applying municipal law in case of state/alien relationship. However, this tradition came to be abandoned as a tendency developed since the mid-1950s to subject the relationship to international legal norms. The causes and purposes of internationalising investment contracts may now be examined.

3.1.1. CALL FOR NEW MECHANISM TO DEAL WITH STATE/INVESTOR DISPUTE

From the perspective of conventional public international law, the relationship between a state and an individual is exclusively a matter of the domestic legal system. Except for a few areas, every sovereign state has an absolute discretion to pass its own laws and enforce them over all persons within its territorial boundary. On the other hand, the traditional notion of private international law that dominated for centuries always looked at the state with which the contract has its closest connection. As a result, the use of such notions in early times led to the inescapable conclusion that the proper law of the contract was the law of the host state.

Besides, there was no practical need to develop choice of law techniques in the field of foreign investment, since the legal system of a colonial state was dependent upon the policy of an imperial state.[1] The investors would get trade or other privileges if they so wanted. For instance,

[1] Sornarajah stated that the need for an international system on foreign investment was minimal in the colonial period. As he observed, within the colonial system the imperial powers and imperial system gave sufficient protection for investments flowing from the imperial states, when the use of force by the imperial states ensured

the British East India Company in India (1600) was pushing for laws of succession which would pass the control of a region to the Company if the ruler had no male successor. [2]

The rule that the host state's law applied to the contract was however changed as a number of arbitral awards of the mid-1950s refused the application of municipal law and introduced public international law in the resolution of disputes between a state and foreign private parties. The primary reason why the theory was created must be linked to the political situation of the period immediately following the end of World War Two.

In 1945, the United Nations (UN) was founded when 50 nations signed the *UN Charter*, which included a statement of its basis in respect for the principle of equal rights and self-determination of peoples.[3] Also, the European colonial powers were weakened, and the balance of power passed firmly to new powers, the US on the one hand and the Soviet Union on the other. These factors, combined with a resurgence of nationalism in the colonial and semi-colonial territories, led to nationalistic movements towards autonomy and independence.

As a result of the struggles for national independence, numerous former colonial territories throughout Asia, Africa and Latin America were freed from colonial dependence. The governments in these newly-independent states began to play a central and pivotal role in their national economies intervening and engaging in the economic affairs of the countries. The role and magnitude of state intervention and the growth of the public sector in the national economies was essential to build strong national economies and to provide social services such as banking and insurance, communications and public transport.

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such protection outside the colonial territories. Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (2nd ed, 2004) 19-20.

[2] Anoushiravan Khoshkish, 'International Law on Investment: An Overview' (1983) 1 *World Policy Journal* 1.

[3] *Charter of United Nations,* opened for signature 26 June 1945, 70 UNTS 238, Art 1 (2) (entered into force 24 October 1945).

More specifically, the Arab countries of the Middle East and North Africa, the world's major oil exporting countries, began to promulgate a set of 'socialist laws'. This was aimed at increasing the role of the public sector in order to, first, facilitate the planning for and implementation of government policies and, secondly, to promote and accelerate economic development of these countries.[4] The enforcement of new legislation and policies led to extensive nationalisation of private enterprises in these countries greatly affecting concession rights of foreigners and leading in some cases to expropriation of their property.

Iran was the first country to nationalise its oil reserves. In 1951, a democratically elected parliament of Iran led by Mohammed Mossadegh nationalised the British owned Anglo-Iranian Oil Company (AIOC). The text of the law nationalising the Oil Industry of Iran read as follows:

> "For the Happiness and Prosperity of the Iranian Nation and for purpose of securing world peace, it is hereby resolved that the oil industry throughout all parts of the country, without exception, be nationalised; that is to say, all operations of exploration, extraction and exploitation shall be carried out by the Government."[5]

The Iranian nationalisation had a colonial character. It was usual for newly-independent countries, especially those ones which had chosen the path of socialist development to carry out economic nationalisations without paying fair compensation.[6] The nationalisations were justified on the grounds that colonists earned their property through illegal means, so the properties

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[4] Following Egypt that embarked on a programme of social reform on the basis of "Arab Socialism" which was introduced and put forward by the *"National Charter"* of 1962 after a series of nationalizations since mid 50s, Syria and Iraq enforced many socialist laws to ensure the involvement of the state in developing the national economies by virtue of its economic activities in the public sector. The ideology of Arab socialism entailed the engagement of the state in the economic affairs in pursuance of the interests of all. For more see Ahmed Jiyad, 'The Social Balance Sheet of Privatization in the Arab Countries' in M'hammed Sabour and Knut Vikør (eds), *Ethnic Encounter and Culture Change* (1997) 179.

[5] Passed by the Majlis on March 15, 1951, and by the Senate on March 20, 1951. *Source of Text*: Iranian Embassy in Washington, DC, Some Documents on the Nationalisation of the Oil Industry in Iran (n.d. [1951] 2 in Alan Ford, *The Anglo-Iranian Oil Dispute of 1951-1952: A Study of the Role of Law in the Relations of States* (1954) 268.

[6] The first nationalisation was carried on by the young Soviet State in 1917-20 of the land, banks, industrial and trade enterprises. Then, other countries which had put on the path of the construction of socialism used nationalization as means of creating state ownership. See M M Boguslavskii, *Private International Law: the Soviet Approach* (1988) 122.

should be returned to the colonial people.[7] Meanwhile, the General Assembly (GA) of the UN also pursued policies supporting the struggles for economic independence.[8] From these points of view, the Iranian nationalisation was a way to establish Iran's sovereignty and ownership of the country's oil industry and resources, end British exploitation in Iran, and mobilize oil resources for the country's future development.

The Iranian oil traditionally was a focus of 'Great Power rivalry' as Dr Ford described.[9] Therefore, the act of nationalisation of the Iranian oil not just caused a dispute between the Iranian government and the AIOC. But it led to political disagreements involving both the UK and the US. The Northern states carried on a desperate struggle against the act of Iranian nationalization. After several failed negotiations with the Iranian government, the USA and Britain organised a joint Anglo-American secret operation and overthrew the democratically elected government with the Shah's dictatorship in 1953. The oil rights were granted in 1954 to a new consortium of Britain and US companies including the AIOC.[10]

Although the Iranian nationalisation did not work, Mossadegh's action subsequently served as a model for the nationalisations of oil industries in Northern and Sub-Saharan African countries such as Egypt (1956), Algeria (1967), Libya (190), Nigerian (1970) and Gabon (1974).[11] In 1960 the Organization of Petroleum Exporting Countries (OPEC) was founded by Saudi

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[7] See n 4 of *Introduction Part* of this Thesis.

[8] Eg, the GA Resolution adopted just after one year later declares that: "… the right of peoples to freely use and exploit their natural wealth and resources is inherent in their sovereignty and is in accordance with the Purposes and Principles of the Charter of the United Nations". *Right to Exploit Freely Natural Wealth and Resources,* GA Res 626 (VII), UN GAOR, 7th sess, UN Doc A/Res/626(VII) (1952).

[9] Ford, above n 5, 3.

[10] *History of Iran Oil Nationalization* (2008) Iran Chamber Society <http://www.iranchamber.com/history/oil_nationalization/oil_nationalization.php > at 23 March 2008.

[11] SEMP INC, *What is Rentier State?* (2005) Suburban Emergency Management Project http://www.semp.us/publications/biot_reader.php/BiotID=227> at 3 March 2007.

Arabia, Venezuela, Kuwait, Iraq, and Iran. After OPEC's founding, oil nationalisations followed in the Gulf countries one by one.[12]

The impact of the nationalisation movements was a devastating blow to the Western economies which were major consumers of oil as well as to the profitability of oil companies.[13] On the other hand, the legal status of foreign investment became highly unstable and uncertain. Under traditional public international law, regulation of nationalisation was the exclusive domain of the state conducting nationalisation. The International Court of Justice ruled that it had no jurisdiction to consider a claim of the UK concerning the nationalisation of the AIOC by the Iranian government because it was nothing more than a concessionary contract between a government and a foreign corporation.[14]

The AIOC also brought the dispute before an English court. Although the court acknowledged that "a British court has no jurisdiction to adjudicate upon the right to ownership or possession of foreign immovables", it ruled that expropriation without compensation is contrary to international law, so the cargo of oil must be returned to the AIOC.[15] But Iran did not accept the jurisdiction of the court on the grounds of its sovereign independence.

Therefore, there was a need to establish a new law-based method to deal with investment disputes between a state and a national or nationals of other states.[16] Oil companies, whose original concessions were changed by the new laws, rejected the laws and demanded that the

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[12] However, other Gulf countries such as Saudi Arabia, Iraqi, and Quiet did not immediately nationalise their oil reserves; rather they took on dominant role in their oil industries by increasing government revenues and reducing the role of foreign companies to contractors. See Sean Finnegan, *Middle Eastern Oil: An Historical Perspective and Outlook* (2003) Mercurial Times http://www.megaone.com/mercurial/mt030525sf1.htm> at 23 January 2008; Amy Jaffe, *Iraq's Oil Sector: Past, Present and Future,* the James A Baker III Institute for Public Policy, Rice University (2007).

[13] See Finnegan, above n 12.

[14] *Anglo-Iranian Oil Co Case (UK v Iran*) [1952] ICJ Rep 93, 24.

[15] *Anglo-Iranian Oil Co Ltd v Jaffrate* (the Rose Mary) [1953] 1 WLR 246, paras 259 and 260.

[16] Sornarajah wrote that the establishment of the United States and the prohibition of aggressive war by its Charter made the use of military pressure no longer feasible. Sornarajah, above n 1, 405.

dispute be arbitrated.[17] As a result, the practice has developed of arbitration between states and private individuals. Before this time, there were only two types of arbitration: domestic arbitration between private parties and international arbitration between states. The first institutional state-investor arbitration was established in 1965 by the *Convention on the Settlement of Investment Disputes between States and Nationals of Other States.*[18]

The new type of arbitration granted to private individuals and corporations a right to bring a claim against national governments with whom they were doing business before international arbitration. On the one hand, it was a very critical approach owing to the fact that in the 1950-mid 1960s non-state actors had no standing in international law. Traditionally, only states had international legal personality which enables them to appear before international courts. On the other hand, it was one of the most significant achievements in terms of protecting human rights under international law.

In fact, the primary objective and focus of the theory of internationalisation to protect foreign investment and foreign investors and accord them better treatment went too far. It erected rigid systems for the protection of foreign investment and was considered to be ignorant of the vital economic development issues of the host state and social matters of foreign investment. The earlier arbitrators tried to enforce highly unequal agreements of colonial past without taking into account their unjust nature for the people of newly-independent countries.[19]

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[17] See further discussions in the next subsection- The Development of the Theory of Internationalisation.

[18] *Convention on the Settlement of Investment Disputes between States and Nationals of Other States,* opened for signature 18 March 1965, 575 UNTS 159 (entered into force 14 October 1966) [hereinafter *ICSID Convention*].

[19] The typical example of colonial concessions is the concession granted to the AIOC by Iran in 1933. Under the contract, the British government was earning much more than the Iranian government was. Documents submitted to by Iranian government to the International Court of Justice provide that:

"According to 1948 balance sheets of the former Oil company, (a balance sheet which is not audited and verified by the Iranian Government), it has made a profit of f62 million, and has also paid f28 million as income tax to the British government. Whereas the taxes paid to the Iranian government in the same year have amounted only to f1,400,000 or 21 times less that the f28 million which had been paid to the British government." See *Anglo-Iranian Oil Co (United Kingdom v Iran)* 29 June 1951 - 10 June 1952, *Other Documents Submitted to the Court*, Part Three, 676.

The theory of internationalisation elaborated by them has been criticized as being greatly affected by political and economic as well as ideological considerations of western policy. As Mohammed noted, "It can be said that arbitral awards in many of the oil dispute cases were made in such a way as to satisfy the interests of a particular community and the laws are manipulated to suit their need, especially in the choice of law clauses".[20] Similarly, Sornarajah wrote: "The story of evolution of the theory [internationalisation] illustrates how 'highly qualified publicists' entrusted with the 'sacred trust' of furthering international law could also pervert it to serve the interests of private power."[21]

The next subsection shows the early stages of the internationalisation of state contracts. The series of arbitrations involved in the creation of the theory may be briefly examined.

3.1.2. THE DEVELOPMENT OF THE THEORY OF INTERNATIONALISATION

Studies showed that the theory of internationalisation is firmly rooted in three arbitral awards on petroleum concession agreements made in mid 1950s between the Middle Eastern States and the western major oil companies. Though each of the three arbitrations- *Abu Dhabi, Qatar and Aramco* cases[22] cited the dictum that the law applicable to the concession agreements is the law of the host state, the arbitrators refused the application of the domestic law, which would have otherwise applied as the applicable law for two reasons.

First, the lack of relevant rules in the legal systems of developing states served as a justification for the application of general principles of law rather than the law of the host state.[23]

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[20] Khalid Mohammed Al-Jumah, 'Arab State Contract Disputes: Lessons from Past'(2002) 17 *Arab Law Quarterly* 215, 227.

[21] Muthucumaraswamy Sornarajah, *The Settlement of Investment Disputes* (2000) 224.

[22] *Petroleum Development Ltd v Sheikh of Abu Dhabi* 18 ILR 144 (1951) ('*Abu Dhabi*'); *Ruler of Qatar v International Marine Oil Company* 20 ILR 534 (1953) ('*Qatar Arbitration'*); *Saudi Arabia v Arabian Oil Co* 27 ILR 117 (1958) ('*Aramco Case*').

[23] However, nowadays the remarks on nonexistence of relevant rules in Islamic law have been disputed by Middle-East writers. For example, Mohammed Al-Jumah criticized the arbitrators in the oil cases because they did not

In the *Abu Dhabi* and *Qatar* cases, arbitrators rejected the law of Abu Dhabi and Qatar on the ground that these national laws were not sophisticated enough to deal such with complex transactions. Particularly, in the *Abu Dhabi* dispute, Lord Asquith acknowledged,

> "If any municipal legal system was applicable, it would be prima facie be that of Abu Dhabi. But the arbitrators then rejected the law of Abu Dhabi arguing, "No such law could reasonably be said to exist…it is fanciful to suggest that in this very primitive region, there is any settled body of legal principles applicable to the construction of modern commercial instruments…".[24]

Another reason for rejecting the domestic law and applying general principles of law to concession agreements was based on the belief of the arbitrators that a concession contract in these terms could not been intended by the private parties. In the *Aramco* case, after hearing the foreign company's argument that the company was unaware of the incompetence of Islamic law at the time of making the concession contract, the arbitrator came to the conclusion, that even though the Muslim law had been agreed by the parties, the dispute should be settled according to law, which a reasonable man would purport to apply.[25]

It should be noted that the first three arbitrations that supported the idea of supranational rules did not really mean that public international law should be the law applicable to concession contracts. Rather they suggested that it would be fair if the concession arrangements were settled "according to the principles of justice, equity and good governance".[26]

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exhaust all possibilities for closing the lacunae within the law and made the conclusion without evidence of experts with deep understanding of local laws. Mohammed Al-Jumah, above n 20, 220.

[24] 18 ILR 144 (1951).

[25] The tribunal justified its decision stating that :

> "Matters pertaining to private law are, in principle, governed by the law of Saudi Arabia but with one important reservation. That law must, in case of need, be interpreted or supplemented by the general principles of law, by the custom and practice in the oil business and by notions of pure jurisprudence, in particular whenever certain private rights –which must inevitably be recognised to the concessionaire if the concession is not to be deprived of its substance-would not be secured in unquestionable manner by the law in force in Saudi Arabia." *Aramco Case* 27 ILR 117(1958).

[26] See *Quatar Arbitration* 20 ILR 534 (1953).

Since general principles of law have been regarded as one of the sources of international law,[27] the reference made in the cases to general principles of law enabled later arbitrators and commentators to build on the conviction that public international law is competent to deal with contractual problems.

The next case that promoted the idea of excluding the application of the host state's law is the *Sapphire Arbitration*.[28] In this case the justification for subjecting disputes between a State and foreign private party to supranational systems of law was the exercise of sovereign power that could change the course of the contract or even terminate it by adopting new regulations.[29] To place the contract beyond the reach of the sovereign power, in *the Sapphire Arbitration* it was held that:

> "…such agreements … should be settled according to the general principles universally recognized and should not be subject to the particular rules of national laws,… and which are always subject to changes by this state and are often unknown or badly known to one of the contracting parties.[30]

Another justification for subjecting the contract to international law was the assumption that foreign investment is beneficial for the development of developing states. Here, Gavin J, the arbitrator observed that economic development agreements should be internationalised to provide the guarantees of protection for foreign investors because"… these companies undergo very considerable risks in bringing financial and technical aid in the process of development".[31] Thus, the case made a proposition that, no matter how adequate the host state's law may be to

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[27] Lord McNair first extended in his article the idea that state contracts should be governed by "the general principles of law recognised by civilised nations" taking the formula from Article 38(1) of the Statute of the International Court of Justice. Lord McNair, 'The General Principles of Law Recognised by Civilised Nations' (1957) 33 *British Year Book of International Law* 1-19.

[28] *Sapphire International Petroleum td v National Iranian Oil Company* 35 ILR (1963) 136 ('*Sapphire Arbitration*').

[29] It was argued that the application of the local law of the host state should be denied where the State exercises its sovereignty to change 'the local law as to end its obligations under the contract'. See Robert Jennings, '*State Contracts in International Law* '(1961) 37 *British Year Book of International Law* 156, 157.

[30] 35 ILR 136 (1963).

[31] *Sapphire Arbitration* 35 ILR 136, 175 (1963).

deal with the problem, the foreign investment contract by nature, is subject to general principles of law.[32]

The ideas reflected in the *Sapphire Arbitration* were carried further in later arbitral awards and provided a support for the theory of internationalisation. The three arbitral awards made in connection with the Libyan nationalisation of oil concessions- *Texaco*, *BP* and *Liamco*[33] agreed that foreign investment agreements should be settled according to rules and principles of public international law, even though Libyan law was "the principal proper law of the contract" in all three concessions.[34] The awards thus went further than others. While in the previous awards such as *Aramco, Qatar* and *Abu Dhabi*, the general principles were applied as distinct from international law, in the *Texaco Case* the general principles of law were applied as part and parcel of the international law.[35]

Apart from the arbitral decisions, the notions of internationalisation also were supported by an impressive body of legal writing. Most scholars from Europe and America were seeking to construct new rules and theories that subjected foreign investment contracts to a legal order other than to a host state's domestic law.[36] Their views however, were difficult to reconcile among themselves.[37] Some opponents of the internationalisation suggested transnational law or *lex mercatoria* as the governing law of disputes between a state and a foreign investor, when some

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[32] Muthucumaraswamy Sornarajah, *International Commercial Arbitration: The Problem of State Contracts* (1990) 20.

[33] *Texaco Overseas Petroleum Company and California Asiatic Oil Company v Libya* 53 ILR 309 (1977) (*'Texaco Award'*); *British Petroleum Exploration company v Libya* 53 ILR 296 (1977) (*'BP v Libya'*); *Libyan American Oil Company v Libya* 20 ILR 1 (1981) (*'Liamco'*).

[34] For detail on the choice of law clause in the Libyan nationalisation cases, see Ch Four, Subsection 4.2.2 (Changing the Tradition of The Party Autonomy Principle).

[35] Mohammed Al-Jumah, above n 20, 225.

[36] See, eg, Lord McNair, above n 27; F A Mann, 'The Proper Law of Contract Concluded by International Persons' (1959) 35 *British Year Book of International Law* 34; Richard Lillich, *The Current Status of the Law of State Responsibility for Injuries to Aliens* (1979) 224; F A Mann, 'The Consequences of an International Wrong in International and Municipal Law' (1979) 48 *British Year Book of International Law* 1; Steven Schwebel, *International Arbitration: Three Salient Problems* (1987).

[37] See further discussions in Ch Three, Subsection 3.2.1 (The Legal Status of Concessions: Contract or Treaty?).

of them supported the construction of a new branch of public international law. Others even considered that a foreign investment contract is a self-governing system which does not belong to any legal system. Later, the views have become a subject of much criticism by another group of scholars, not only from developing states.[38]

3.1.3. THE ICSID AND THE CHOICE OF LAW

The next step in the evolution of the choice of law principles in the area of foreign investment contracts was the adoption of the *ICSID Convention* on March 18, 1965 by the World Bank (former International Bank for Reconstruction and Development). Unlike numerous multilateral treaties in the field of international trade and commerce which aim to achieve uniformity in the application of the law, the *Convention* alone did not tried to adopt uniform substantive rules. Instead, it welcomed the use of traditional private international law principles to contracts between a state and a foreign investor.

Article 42 of the *Convention* provides the hierarchy of applicable laws, in sequence of importance:

(a) Law chosen by the parties;

(b) In the absence of a choice of law

(i) Law of the Contracting State party to dispute;

(ii) Law of some other state as a result of contracting state's conflict of laws;

(iii) Rules of international law.

[38] See Horacio Naón, 'Arbitration in Latin America: Overcoming Traditional Hostility' (1989) 5 *Arbitration International* 137; Sornarajah, above n 32; Okezie Chukwumerije, *Choice of Law in International Commercial Arbitration* (1994); A F M Maniruzzaman, 'State Contracts in Contemporary International Law: Monist versus Dualist Controversies' (2001) 12 (2) *European Journal of International Law* 309; Mohammed AL-Jumah, above n 20.

Therefore, it is clear that the *Convention* primarily accepts the subjective theory of choice of law based on the principle of party autonomy or the will of the parties.[39] It has been observed that the *Convention* provides parties with a broad discretion as to the identification of the law governing their relationship.[40] By authorizing parties to agree on the "rules of law" applicable to their contract, the *Convention* intends to make clear that the choice of parties is not limited to one or more national laws or legal system but may refer to, for example, "more fluid concepts like those general principles of civilized nations as something distinct from international law, or transnational law or the new law merchant".[41] Also, the term "rules of law" is believed to be permissive that the parties are not restricted to choosing a national law or part of it at all.[42]

Though the drafters of *Convention* adhered to the principle of party autonomy, one doubts whether this principle that primarily has been effectively used in the field of purely commercial contracts is also suited for the field of international investment contracts that involve the public interest. Not surprisingly, investor/state arbitral tribunals often do not apply the party autonomy rule the way it used to be. Moreover, as a matter of fact, both parties to a state contract still may face barriers to enforcing a contractual choice of law. These issues will be discussed in greater detail in other chapters of the thesis.[43]

The next principal method of determining the applicable law of foreign investment contracts is the national law approach. As the Art 42 (1) of the *Convention* further states, the law

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[39] The first sentence of Art 42 (1) of the *ICSID Convention* expressly states: *"the tribunal shall decide dispute in accordance with such rules of law as may be agreed to by the parties".*

[40] See Ibrahim Shihata and Antonio Parra, 'Applicable Substantive Law in Disputes between States and Private Parties: The Case of Arbitration under the ICSID Convention' in Albert Van Den Berg (ed), *Planning Efficient Arbitration Proceedings: The Law Applicable in International Arbitration* (1994) 294, 298.

[41] Arshad Masood, 'Law Applicable in Arbitration of Investment Disputes under the World Bank Convention' (1973) 15 *Journal of Indian Law Institute* 311, 317. The relevant passage is set out in full at n 117 of Part Four.

[42] Aron Broches, 'Convention on Settlement of Investment Disputes between States and Nationals of Other States of 1965: Explanatory Notes and Survey of its Application' (1993) XVIII *Yearbook Commercial Arbitration* 627.

[43] See Ch Four, Section 4.2. (Controversies Related to Private International Law), Ch Eight, Section 8.1 (The Rule of Free Choice in ICSID Arbitrations), and Ch Eight, Section 8.2 (Barriers to Parties' Freedom of Choice).

to be applied by the ICSID tribunal to the substance of the dispute (in the absence of parties' choice of law) is "…the law of the Contracting State party to the dispute (including its rules on the conflict of laws)…" Indeed, the role of national laws in resolving disputes between a state and its private partner is essential. National law was the natural choice for such contractors even before the enactment of ICSID, and it remains so until the present. According to a survey made in the 60-70s, more than half of 80 economic development agreements were made subject to the law of the host state.[44] The significance of ICSID in this regard is that it did not try to undermine the role of the law of the host state as the previous arbitral tribunals had done.

At the same time, the Convention also proposed simultaneously the application of international rules. But the proposition has been debated. It served the claims of opponents of internationalisation that public international law is relevant in relationships between a state and a foreign individual, and applicable in the same way that national law is. In simple terms, the creators of the theory further had twisted the meaning of the article and claimed that international law is always relevant regardless of chosen law. But this view is objectionable and seems contrary to the spirit of *ICSID Convention*. The supporters of internationalisation have failed to acknowledge that the Convention does not undermine the significance of national law: conversely it put it in the first place. As the World Bank's General Counsel, Aron Broches, assured the legal committee for the drafting of the *Convention*, the law of the host state would be of primary importance in deciding investment disputes and international law might in the first place refer to national law itself.[45]Also, as one writer observed, the wording

[44] See Aron Broches, *Selected Essays: World Bank, ICSID, and Other Subjects of Public and Private International Law* (1993) 530.

[45] *History of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States:* Documents Concerning the Origin and the Formulation of the Convention 1 (English), Washington DC 1968 at 800-1.

of Article 42 does not reflect a preference for any of the laws when there is any inconsistency between the two bodies of law.[46]

Finally, although the *ICSID Convention* principally concerns procedural matters for settling investment disputes, it has given some guidance on the applicable law issue. What is important is by ratifying the practices previously followed by arbitrators, the convention has given these practices a degree of certainty which they lacked until then.[47]

3.2. Doctrinal Foundations of the Theory of Internationalisation

The practical need to prevent deliberate evasion of the law of the state which would have jurisdiction has led to the development of a number of arguments in favour of the application of international law. Because of the doubtful foundations on which the notion of internationalisation rested, there was a need for other mechanisms which could reinforce it. This mechanism was built by further efforts of supporters of the theory of internationalisation through their arbitral awards and writings.

3.2.1. THE LEGAL STATUS OF CONCESSIONS: CONTRACT OR TREATY?

The basic argument that supports the relevance of international law to concessions was the idea proposed by the opponents of the theory of internationalisation that concessions have a peculiar nature so that they cannot be considered as mere commercial contracts. Supporting the idea of applying international law to concession contracts, the opponents of the theory however, had viewed this from different angles.

The main argument for subjecting concessions to international law came from the assumption that concessions are akin to a treaty. In positivist international law, an agreement

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[46] George Elombi, 'ICSID Awards and the Denial of Host State Laws' (1994) 11 (3) *Journal of International Arbitration* 1-68.

[47] Philippe Kahn, 'Law Applicable to State Contracts: The Contribution of the World Bank Convention' (1968) 44 *Indiana Law Journal* 1, 18.

between the state and a foreign private party was regarded as a contract which was subject to the state's law, and international law did not have a role to play in the agreement.[48] Thus, the only way to subject concession contracts to international law was the equation of these contracts to international treaties.[49]

As Kissam and Leach claimed in their work written mid 20th century[50], contracts between a State and foreign private parties should be regarded as equivalent to treaties between two States because they are governed by international law. As they observed, "in both cases promises with an international scope are made; in both cases reliance is placed on those promises; in both cases the obligation to perform those promises should be the same." Such a claim however was ill-founded automatically putting the parties on the equal footing, when the parties have different legal status in the international legal order.

With respect, it is now strongly believed by academics and judges that the analogous application of treaty rules to investment agreements is not acceptable.[51] For example, Sornarajah rejected the firm proposition that the agreements amount to treaties by admitting that:

> "The assimilation of foreign investment agreements to treaties is a non-starter as the law on treaties was never developed in contemplation of its application to foreign investment agreements. The argument that the Vienna Convention on the Law of Treaties could be applied to foreign investment agreements is too fanciful to have any

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[48] "…any contract which is not a contract between states in their capacity as subjects of international law is based on the municipal law of some country." *Serbian Loans Case (France v Serbia)* [1929] PCIJ (ser A) No 20, 41; See also *Anglo-Iranian Oil Company case (UK v Iran)* [1952] ICJ Rep 93, where the Court held that the concession agreement was not "a treaty or convention" and refused to assume jurisdiction over a claim of the government of England in relation to the Iranian nationalisation.

[49] Maniruzzaman noted that such assimilation intended to oblige a State party in foreign investment contracts by international obligations arising out of treaty law. A F M Maniruzzaman, 'International Development Law as Applicable Law to Economic Development Agreements: A Prognostic View' (2001) 20 *Wisconsin International Law Journa1* 1, 5.

[50] Leo Kissam and Edmond Leach, 'Sovereign Expropriation of Property and Abrogation of Concession Contracts' (1959) 28 *Fordham Law Review* 177, 207.

[51] For scholarly writings that support this view, see Ian Brownlie, *Principles of Public International Law* (4th ed, 1990) 550; Oscar Schachter*, International Law in Theory and Practice* (1991) 309. For judicial support for the view, see *Anglo-Iranian Oil Co Case (UK v Iran)* [1952] ICJ Rep 93; *Amoco International Finance Corporation v Government of Islamic Republic of Iran,* (July 1987) 15 Iran-US CTR 189, 242-243.

> merit, as the Convention was not made by the parties to apply to anything other than agreements between States. It is unnecessary to clutch at such straws if the argument that has made any inherent strength."[52]

Meanwhile, the view that a foreign investment contract is not a treaty is fully consistent with the rules on the definition of treaties laid down in the *1969 Vienna Convention on the Law of Treaties*.[53] According to the description of a treaty contained in the *Vienna Conventions,*[54] one of the essential characteristics of a treaty is that it has to be concluded by states or international organisations with treaty-making power. But concession contracts do not qualify as having such a character.

Another theory that intended to exclude the laws of the host state was Verdross' theory of contract without law (also known as a concept of quasi-international agreements). This is based on the conviction that the concessions need not to refer to a specific legal system, but rather it is subject to a new juridical order, ie the agreed *lex contractus*.[55] Verdross and his supporters have maintained that agreements concluded between a state and a private party are 'quasi international agreements" meaning that they are neither governed by the municipal law of

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[52] Muthucumaraswamy Sornarajah, 'Power and Justice in Foreign Investment Arbitration' (1997) 14 *Journal of International Arbitration* 119.

[53] *Vienna Convention on the Law of Treaties,* opened for signature 23 May 1969, 1155 UNTS 331 (entered into force 27 January 1980). Art 2 of the Convention provides:

"a treaty is an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation".

[54] The *1986 Vienna Convention* extends the definition of treaties to include international agreements involving international organizations as parties. See *Vienna Convention on the Law of Treaties between States and International Organisations or between International Organizations,* opened for signature 21 March 1986, Art 2 (not yet in force).

[55] Prof Verdross, the leading advocate of this theory of quasi international contracts wrote:

> "The contract, created by a quasi international agreement, is an independent legal order, regulating the relation between the parties exclusively. Naturally, the *lex contractus* may refer, for its interpretation or the filling up of eventual gaps, to the legal order of the contracting state, or of the other party, or to international law. But these legal orders can only be applied in as much as they are delegated by the *lex contractus*, because it is the mutual rights and duties of the parties." See Alfred Verdross, 'The Status of Foreign Private Interests Stemming from Economic Development Agreements with Arbitration Clauses' in *Selected Readings on Protection by Law of Private Foreign Investments* (1964) 125.

a State nor by public international law. However, the theory has being criticized as leading to lawless contract, and it could not have been accepted widely confronting serious opposition.[56]

The third theory that supported the relevance of international law to concessions is a theory which was known as "doctrine of the New Law Merchant" or the *lex mercatoria* of the 1960s.[57] The new theory emerged subjecting legal relations concerned with international commercial law to the extensive body of rules which includes national laws, general conditions elaborated by practitioners, and also bilateral and multilateral treaties, arbitration precedents, etc. Although the ideas of the theory were slightly different from each other, the basic point of departure was that foreign investment contracts are subject to a new legal order primarily consisting of general principles of law, custom and treaty rules. The doctrine resembles to a degree to the conception of transnational law termed by Phillip Jessup in his celebrated work, *Transnational Law*. As he wrote in here;

> "I shall use, instead of "international law," the term "transnational law" to include all law which regulates actions or events that transcend national frontiers. Both public and private international law are included, as are other rules which do not wholly fit into such standard categories."[58]

Thus, many supporters of the theory of internationalisation proposed the formulation of such a new body of law, even though there was no general consensus among them as to what this law is named and what it should contain. Prof Dupuy in the *Texaco Award* gave no clue what the nature and content of the new branch of international law could be, simply labeling it 'the international law of contracts".[59] Dr Mann, one of the leading advocates of the theory of

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[56] Mann criticised the theory of quasi international contracts that such an idea is 'doctrinally so unattractive, so impractical, so subversive of public international law, so dangerous from the point of view of legal policy.... It hardly requires emphasis that every legal relationship in general and every contract in particular must be governed by a system of law and is otherwise 'unthinkable'." Mann, above n 36, 49.

[57] Kahn, above n 47, 18.

[58] Phillip Jessup, *Transnational Law* (1956) 3.

[59] *Texaco Award* 53 ILR 389 (1977), para 32.

internationalisation, on the other hand, believed that a new body of law that applies to the relationship between states and private parties was in the course of formation referring to it as 'the commercial laws of nations'. According to him, the further development and consolidation of commercial law of nations would come about through a most comprehensive investigation and analysis of various legal systems, in particular the private law doctrines which provide the principal source of the emerging rules.[60]

Such a hybrid system of law was artificial and unrealistic partly due to its mysterious character and partly due to its invalidity as a governing legal rule.[61] Despite this, in the arbitration cases of the 1950s and 1960s it was extensively referred to such general principles of law equity, *amiable composition*, good faith, trade practices and international economic law, composed essentially of treaty rules.[62] The idea of a new branch of law may be solid evidence that, from the outset, the arbitrators knew that international law itself could not be the law of contract. In other words, those who embraced the theory of the new law merchant did not intend the application of public international law in the traditional sense, but rather suggested a new body of law something similar to *lex mercatoria* in international trade.

3.2.3. INCLUSION OF CONTRACT CLAUSES

One of the efforts to internationalise the contract was the inclusion of certain types of clauses in foreign investment contracts such as stabilisation clauses, arbitration clauses, and choice of law clauses to indicate that the contract was subject to an external regime and not solely to the laws of the host State. To examine the strength of the theory of internationalisation,

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[60] F A Mann, 'Reflections on a Commercial Law of Nations' (1957) 33 *British Year Book of International Law* 20, 48.

[61] In assessing the position of the new law of merchant after its first 20 years, Lord Mustill was able to gather 20 principles, most of which are too broad and too general to be applied as governing legal standard. Michael Mustill, 'The New Lex Mercatoria: The First Twenty Years' (1988) 4 *Arbitration International* 2.

[62] It was concluded in the *Abu Dhabi*, *Aramco* and *Sapphire* arbitrations that investment disputes should be settled according to commercial law of nations. See *Abu Dhabi* 18 ILR (1951); *Aramco Case* 27 ILR (1958); *Sapphire Arbitration* 35 ILR (1963).

it is necessary to consider the validity and effects of such clauses that justify the relevance of public international law.

Stabilisation clause

Stabilisation clauses first emerged in arbitration practice as arbitral awards of the late 1970s confirmed the validity of the clauses without considering the question of their validity under relevant theories.[63] In general, there are three possible ways of stabilising the contract.[64] Firstly, the state law can be frozen precluding the application of any further changes of subsequent legislation that would otherwise apply to the contract. Examples of this kind of strict clause are usually found in traditional concession agreements. For instance, a stabilisation clause contained in a Concession Agreement of 1933 between the State of Iran and Anglo-Iranian Oil Company reads as follows:

> "Concession shall not be annulled by the Government and the terms therein contained shall not be altered either by general or special legislation in the future or by administrative measures or any other acts whatever of the executive authorities."[65]

According to the second method, obligations under the contract can be altered only by the mutual agreement of the parties. The concession agreement discussed in the *Texaco Arbitration* contained a clause which reads as follows,

> "Government of Libya will take all steps necessary to ensure that the company enjoys all the rights conferred by the concession. The contractual rights expressly created by this concession shall not be altered except by the mutual consent of the parties".[66]

Lastly, any subsequent legislation is inoperative if it is inconsistent with contractual provisions or has a material adverse effect on it. A modern stabilisation clause, which is designed

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[63] The following is a list of earlier cases where a stabilisation clause is found. *Lena Goldfields v USSR*, 5 Annual Digest 3 (1930); *Aramco Case* 27 ILR 117(1958); *Sapphire Arbitration* 35 ILR 136 (1963); *Texaco Award* 53 ILR (1977) ; *AGIP Co v Popular Republic of Congo* 21 ILM 726 (1982); *American Independent Oil Company v Kuwait Independent Oil Company v Kuwait* 21 ILM 976 (1982) ('*Aminoil Award*').

[64] See Chukwumerije, above n 38, 144.

[65] Art 21, *Agreement between the Imperial Government of Persia and the Anglo-Iranian Oil Company,* Limited Made at Tehran on 29 April 1933 available at < http://peymanmeli.org/oil2.asp > at 22 January 2008.

[66] 53 ILR 389 (1977).

for a product-sharing, participation, or service agreement fits into this category. An example of the clause was cited by Prof Anderson and it provides as follows:

> "After the effective date of this agreement, if there is a change in the domestic law that results in a material adverse impact on the economic value derived from operations by the contractor, the state (NOC) will ensure that the contractor will derive the same economic benefits as it would have derived if the change in law had not been affected."[67]

Thus, the role of a stabilisation clause in the investment contract is to prevent the state party from changing its own law to the detriment of a foreign investor and breaching the contract obligations on the ground of the change. In other words, the clause is intended to freeze the host state's law at the time of entry of the foreign investor and to ensure that only the freezing law controls the foreign investment.

However, the legal foundations of the stabilisation clauses are very suspect and the legality of the clauses has been amply discussed by international lawyers.[68] First of all, it is theoretically unconvincing to bind a state legislature by a mere contractual provision.[69] It has been pointed out that the stabilisation clause attacks the asserted sovereign right of the host state to legislate according to changing social and economical frameworks.

Second, due to the complexity and long term nature of investment contracts, this type of contracts naturally requires flexibility but not stability.[70] In this sense, stabilisation clauses are

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[67] Owen Anderson*, Risk: Emphasising Political Risk*, CEPMLP Course Materials, Contracts Used in International Oil Industry Development, Slides p18-19 CEPMLP June 2003.

[68] See Enid Campbell, *Legal Problems involved in Government Participation in Resource Projects* (1984); Esa Paasivirta, 'Internationalisation and Stabilisation of Contracts versus State Sovereignty' (1989) 60 *British Year Book of International Law* 315. Also, it is claimed that the clause inhibits the exercise of the State right to permanent sovereignty over natural resources. See Eduardo Arechaga*,* 'Application of Rules of State Responsibility to the Internationalization of Foreign-Owned Property' in Kamal Hossain (ed), *Legal Aspects of the New International Economic Order* (1980) 230.

[69] It is very likely that domestic courts would not enforce the stabilisation clauses because the idea of freezing the host state's law is unacceptable under legal concepts embedded firmly in many domestic legal systems. One of the strongest principles is the English doctrine of executive necessity which forbids a government to fetter its executive action by a contract. For a discussion of this principle see Ch One, Subsection 1.1.2 (Comparative law on Public Law Contracts), (ii) State Contracts in Common Law Countries.

[70] In recent years there has been an increasing trend toward including renegotiation clauses in development agreements which may seem the proof of the fact that investment agreements must be flexible. For more see,

incompatible with a host country's changing needs of development. Even the international arbitrations themselves have recognised the impossibility of controlling the future of national economy by stabilisation promises. Particularly, in the *Aminoil Award*, the tribunal while stating that "no doubt contractual limitations on the State's right to nationalise are juridically possible, but what that would involve would be a particularly serious undertaking…",[71] it hold that it cannot interpret the stabilisation clauses of the concession contract "as absolutely forbidding nationalisation…"[72]

Besides, there is a trend towards recognising the impact of changed circumstances on contractual undertakings. As a study shows, renegotiating and adapting long-term commercial contracts in case of unforeseen and unregulated external events has become widespread practice over the last 30 years.[73] As a result, stabilization clauses which were included in earlier types of concession agreements have been replaced by newer types of provisions that allow for the regular review of long-term investment contracts.[74] Furthermore, there are no general comprehensive rules at both the international and national levels which can give the stabilisation clause a legal power. Some countries do provide stabilisation promises to attract foreign investment.[75] But when specific legal problems arise from the attempt to stabilise investment conditions, it is hard to uphold the clause.

Thomas Wälde and Abba Kolo, 'Renegotiation and Contract Adaptation in the International Investment Projects: Applicable Legal Principles and Industry Practices' (2000) 1 (1) *Journal of World Investment* 5, 6.

[71] *Aminoil Award,* 21 ILM 976 (1982), para 95.

[72] Ibid, para 96.

[73] Waelde and Kolo, above n 70.

[74] Peter Muchlinski, *Multinational Enterprises and the Law* (1999) ch 14.

[75] *Foreign Investment Law 1999* of Russia provided a tax stabilization protection for duration of seven years, but in practice, these protections have not been provided because the implementing regulation never passed. US - Russia Business Council, *Russian Economic Survey* (May 2007) 12 <https://www.usrbc.org/pics/File/EconSurvey/SurveyMay2007.pdf > at 23 March 2008.

Particularly, the ruling of the *Comalco Case*[76] provides an excellent example of how promises made by a state no matter how they are clearly drafted can turn into an unenforceable agreement at the exact moment. In the Australian case, the plaintiff entered into an agreement with the Premier of Queensland for the exploitation of mineral deposits in Queensland. The agreement had provisions which read as follows:[77]

> "Upon the making of the Agreement the provisions thereof shall have the force of law… The agreement may be varied pursuant to agreement between the Minister for the time being administering this act and the Company with the approval of the Governor in Council by Order in Council and no provision of the agreement shall be varied nor the powers and rights of the Company under the Agreement be derogated from except in such manner.

Then, the Queensland Parliament enacted the *Mining Royalties Act 1974* under which the royalties payable by the plaintiff under the 1957 Agreement were increased. In considering two inconsistent provisions found in two Acts of Parliament, the majority judges concluded that an entrenchment provision relates only to the executive power to amend or vary the agreement, and not to the legislative power so to do.[78] Therefore, the Supreme Court of Queensland held that the *Mining Royalties Act 1974* (Qld) could validly alter the royalty provisions of the agreement between Commonwealth Aluminum Corporation limited and the Premier of Queensland.

In Mongolia, the *Foreign Investment Law* (1993) permits the concluding of stability agreements by foreign investors.[79] But it is hard to implement such a critical provision of law in actual practice. For instance, the negotiations on a stability agreement between the Mongolian Government and Ivanhoe Mines, a Canadian mining company have faced with strong public

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[76] *Commonwealth Aluminium Ltd v Attorney-General* (1976) Qd R 231 *('Comalco Case').*

[77] *Commonwealth Aluminium Pty Limited Agreement Act 1957*, ss 3 and 4.

[78] *Comalco Case* (1976) Qd R 231, 239.

[79] Art 19 (2) reads as follows:

> "…This agreement shall contain provisions to ensure stable tax conditions during certain period and state objectives and amount of the investment, its implementation period and rationale to revoke the agreement."

protests.[80] Mongolian civil society groups accused the government in putting the interests of people of Mongolia in a disadvantaged position by concluding an unfair agreement with foreign investors.[81]

Even when the stabilisation agreement is reached, this might cause other problems such as an issue of inequality. As a matter of constitutional theory, everyone must be equally subject to law. Thus, the discriminatory favours granted by stabilisation clauses to foreign investors are likely to arouse political criticism from domestic entrepreneurs against the government negotiators.[82] It also should be noted that because foreign investment contracts are not treaties, they are usually concluded by state officials, who are not in a high position and do not represent the State.[83] The conclusion of contracts signed by officials of the state who lack legislative authority may lead to the unenforceability of the contract.

Given the evidence, it can be inferred that stabilisation guarantees are suspect and unreliable even in cases where states themselves promise not to alter their legislation. As one commentator observed,

> "The clause may not serve as anything more than a comforter to the foreign investor who just believes that his partner, a foreign state, would keep its promise not to apply its future law to the contract".[84]

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[80] The negotiations between the Mongolian Government and Ivanhoe Mines on the Oyu tolgoi project have been discussed for 5 years now. The Oyu tolgoi is a massive copper-gold project estimated at 40 years with an average yearly production of 1.6 billion pounds of copper and 330,000 ounces of gold.

[81] B. Bulganmaa, *Demand for Government to Come Clean on Oyu Tolgoi* (January 17 2007) The UB Post-Leading English News <http://ubpost.mongolnews.mn/index2.php?option=com_content&do_pdf=1&id=342 > at 25 June 2007. Also see *Analysis of the Proposed Investment Agreement between the Government of Mongolia and Ivanhoe Mines Mongolia Inc* (2007) Policy Documentation Centre <http://pdc.ceu.hu/archive/00003652/04/ivanhoe_mongolia.pdf > at 26 June 2007.

[82] Thomas Waelde and George N'Di, 'Stabilising International Investment Commitments: International Law versus Contract Interpretation' (1996) 31 *Texas International Law Journal* 215, 224.

[83] It is not competent for these officials to stabilise the law of the State, unless that law authorizes them to do so. Under the theory of separation of powers it is the sole prerogative of the legislature to determine whether there is a need to change its legislation pursuant to national interest of the state. As the executive, the government's role is to put laws into effect enforcing rights and obligations prescribed by the legislature rather than to make a decision that is not in its power.

[84] Sornarajah, above n 1, 408.

Choice of law clause

The second clause, which seeks to exclude the application of the municipal law in investment agreements, is the choice of law clause. As Higgins stated,

> "…the best way to avoid sole reliance on domestic law is one has to say, by having a governing law clause that introduces international law."[85]

The inclusion of a choice of law clause into foreign investment contracts has caused less trouble than the inclusion of stabilisation clauses. The clause derives its validity from the world-wide recognised principle, party autonomy, which permits parties to choose their legal system of preference to govern the contractual relationship. From the perspective of private international law, such a choice of law by parties must be respected and enforced.

However, there are several insuperable objections to the use of the clause in foreign investment contracts. Primarily, the traditions of applying the choice of law rules have been violated in two cases. First, the opponents of the theory of internationalisation have transferred the choice of law rules which used to apply only to matters in the domain of private law into matters of public law such as taxation and expropriation issues.

As a general rule, public law cannot be excluded by agreements of the parties. Thus the choice of law clause is only valid if the matter of a dispute raised between parties concerns the application of private law. Otherwise, the choice of law clause has no effect on matters exclusively in the domain of public law. As far as foreign investment contracts are concerned, only issues concerning the form and the term of contract, performance of obligations, and contractual rights can be subject to the rules and principles of contract law, including choice of

[85] Rosalyn Higgins, *Problems and Process: International Law and How We Use It* (1994) 141.

law techniques. But issues such as expropriation, nationalisation, taxation, labour regulation and environment protection are subject to public law. [86]

Secondly, the theory suggests that international law superimposes parties' choice. This is something peculiar to the traditional rules of private international law that upheld the will of the parties to a contract in a contractual situation. Obviously, there is no doubt that mandatory rule of international law which is independent of any conflict rules will be superimposed on the parties' choice. But in the context of the theory of internationalisation, it has been stated that international law is relevant as the whole system, and not only mandatory rules. This is one of the greatest controversies of the theory and this will be discussed in the following chapter.

Arbitration clause

Another clause intended to subject the investment contract to an external regime is the arbitration clause as the sole means of dispute mechanism. By using such a clause, the parties to the contract agree to arbitrate any future disputes. In other words, the insertion of the clause in the contract guarantees foreign investors the exclusion of the jurisdiction of domestic courts of the state party.

Like the choice of law clause, the arbitration clause is widely used in contemporary commercial practice. With the expanding international economic activity and globalisation, the use of the arbitration mechanism of dispute settlement has been increased. The voluntary

[86] Maniruzzaman rightly stressed that:

> "One cannot, however, pretend to say that an investment agreement can be governed exclusively by international law or by general principles of law or for that matter by the *lex mercatoria* or the UNIDROIT Principles of International Commercial Contracts (1994) in the face of the reality that there are many matters relating to a contract which must inevitably be subject to the law, especially the mandatory public law rules or public policy rules, of the host State where most of the operations under an investment development agreement take place." Maniruzzaman, above n 49, 31.

nature of the arbitration process provides parties with the opportunity to make the process very flexible and adaptable without much interference from public bodies.[87]

But, despite its growing role and success in international commercial operations, arbitration has had little success in the settlement of commercial disputes which involve a state. The reasons are due to a number of practical reasons as well as theoretical constrains. First, the arbitration mechanism in the field of state/foreign private party disputes is a recent phenomenon compare to the international commercial arbitration practices that for several hundred years have proven to be an efficient, capable and practical alternative to compulsory dispute settlement by the State.

Then, many developing states were suspicious about the arbitration methods of settling investment disputes until the adoption of ICSID arbitration.[88]As Sornarajah noted,

> "since international arbitration had its genesis in the framework of international law rules on investor protection, it is regarded as tainted with the same faults of prejudice and partiality".[89]

Furthermore, because of its voluntary nature and private character, arbitration has been seen as an unsuitable mechanism for commercial disputes which have a public interest element. As Lazar claimed, arbitral tribunals are not designed to be forums for balancing competing social, economic, environmental and political concerns."[90] In its common sense, arbitration is a private system resolving disputes without laws or juries.[91]

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[87] For example, arbitration offers the parties the opportunity to choose their own decision-maker while that is usually not possible in court proceedings.

[88] Jan Paulsson wrote: "The historical distrust of international arbitration on the part of developing countries arose principally in South America, for the simple reason that until the watershed decade 1955-1965, other developing regions were mainly colonized and therefore had no voice with which to raise protests against imposed from abroad." See Jan Paulsson, 'Third World Participation in International Investment Arbitration' (1987) 2 *ICSID Review-Foreign Investment Law Journal* 19, n 1.

[89] Sornarajah, above n 32, 9.

[90] Lazar further wrote, "With the institutionalisation of arbitration as a *de facto* dispute resolution regime, there is a risk that the global trading regime will provide financial interests with an unprecedented and decidedly

Apart from the above defects of arbitration in this field, there are also some issues that reduce the effectiveness of arbitration clauses in state contracts. In the first instance, even though now there is an increasing assurance that the state has no sovereign immunity over the other party of the contract in governmental transactions of a commercial nature such as the sale or leasing of real property, the restrictive theory of sovereign immunity has not been recognised universally.[92] According to the principle "*par in parem non habet imperium"* rejecting the subjecting of one State to the jurisdiction of another State, only public international law tribunals have the capacity to question the actions of states towards their violations of international obligations.

On the other hand, it should be realised that disputes arising from commercial transactions with a state often involve matters of public law. Under most national legal systems, public law disputes are not arbitrable. Thus, if the source of the dispute is classified as regulatory, the arbitration method of the dispute may not be is possible.[93] For instance, under the Brazilian Law on Arbitration which applies to both national and international arbitration, questions connected to antitrust and unfair competitions, as well as environmental regulations, where the public interest is involved, are not arbitrable.[94]

Finally, the role of the arbitration clause as a strategy of excluding domestic legislation can be reduced by the mere fact that the choice of arbitration itself does not affect the choice of substantive law. When the arbitration clause is included in a contract, only the procedural rules of

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undemocratic opportunity to challenge restrictions and regulations which they [corporations] believe hinder their ability to do business." Lydia Lazar, 'NAFTA: Structural Damage to the Ship of State?' in Henry Perritt (ed), *2001 Employment Law Update* (2001) 169. Also see Sornarajah above n 32, 164.

[91] According to some arbitration rules, arbitrators do not have to be lawyers. For example, there is no requirement under the ICC Rules of Arbitration that the co-arbitrators, the chairman of an arbitral tribunal or a sole arbitrator be a lawyer. See *ICC Rules of Arbitration* in force as from 1 January 1998.

[92] Georges Delaume, 'Sovereign Immunity and Transnational Arbitration' (1987) 3 (1) *Arbitration International* 45.

[93] However, in a few countries there has been a tension in favouring arbitration of certain public law-related disputes. For example, in the United States courts have authorised arbitration of securities related claims and claims brought under competition legislation. See Mahmood Bagheri, *International Contracts and National Economic Regulation* (2000) Ch VI.

[94] *Brazilian Law No 9.307of 23 September 1996*, ANNEX I.

arbitration apply. The clause cannot guarantee the application of international law, so international arbitrators still may apply local law.[95] Particularly, the World Bank's Convention permits an ICSID tribunal to apply in the absence of a choice of law by parties the law of the host state.

3.2.3. UTILISATION OF LEGAL DOCTRINES

The next effort to make public international law relevant to state contracts rested on transference of the notions of other areas of law such as party autonomy, *pacta sunt servanda* and *acquired rights,* to foreign investment contracts The problems of applying the principle of party autonomy to state contracts will be separately discussed in the last chapter of the thesis. Two other doctrines, on which the theory of internationalisation rested heavily, now have to be examined.

Pacta sunt servanda

This doctrine is used to provide the foundation of the binding force of treaties in international law and of contracts in private law. In other words, it is a principle of both treaty law and contract law that obliges parties to keep their promises. In its most common sense, it refers to private contracts, stressing that contract promises are law between the parties, and implies that the non-fulfilment of those promises is a breach of the law.

Now, *pacta sunt servanda* is widely accepted as a basic legal principle in international instruments. The Article 26 of *Vienna Convention on the Law of Treaties* states, "every treaty in force is binding upon the parties to it and must be performed by them in good faith." Also, norms that impose legally binding obligations of international commercial contracts are found in *UNIDROIT Principles of International Commercial Contracts*, 2004.

[95] Chukwumerije wrote, "Arbitration clauses are not signposts indicating the intention of parties to internationalize their agreement. Assuming that arbitration clauses should play a role in determining the choice of law, it is not clear why such clauses should be interpreted as necessitating the application of international rather than municipal law. Chukwumerije, above n 38, 159.

The early arbitral awards of 1950s and 60s supporting the theory of internationalisation had relied on *pacta sunt servanda* to bind the state party absolutely to a concession contract by the promises made in the contract no matter what changes occurred after signing the contract.[96] Particularly, in the *Texaco Award*, the arbitrator held that:

> "…the recognition by international law of the right to nationalise is not sufficient ground to empower a state to disregard its commitments, because the same law also requires the power of a state to commit itself internationally, especially by accepting the inclusion of stabilisation clauses in a contract entered into with a foreign private party."[97]

The case suggested that the state was unable to remake contracts they made. Thus, the opponents of the theory of internationalisation tried to show that the principle of *pacta sunt servanda* was an inflexible doctrine which did not admit any exceptions.[98] In fact, one must accept that *pacta sunt servanda* is not an absolute principle. The principle of *rebus sic stantibus* is universally considered as a dangerous exception to the principle of *pacta sunt servanda* it.[99] Both contract law and treaty law recognise *rebus sic stantibus.*[100]

The competing doctrine makes treaty or contract binding only in situations where the original conditions under which the treaty or contract was made. But the early arbitral tribunals had ignored the principle which has the same validity and acceptance as *pacta sunt servanda* in

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[96] It was affirmed vigorously in *Aramco Case*, the *Sapphire Arbitration* and *Texaco Award*. See *Aramco Case* 27 ILR 117 (1958); *Sapphire Arbitration* 35 ILR (1963); *Texaco Award* 53 ILR (1977).

[97] Ibid, *Texaco Award,* para 71.

[98] Sornarajah, above n 32, 20.

[99] Chengwei Liu, *Remedies for Non-performance: Perspectives from CISG, UNIDROIT Principles & PECL* (2003) Pace law School at <http://cisgw3.law.pace.edu/cisg/biblio/chengwei.html> at 27 May 2004.

[100] The *Vienna Convention on the Law of Treaties of 1969* (under Arts 61 and 62) recognizes the instances where performance can be excused because of extraneous events. Art 61 recognises situations in which performance has become impossible because the object of the treaty is unavailable. Art 62 provides for instances where, due to a fundamental change in the circumstances in which a treaty was concluded, the parties' obligations have become radically transformed. *Vienna Convention on the Law of Treaties,* opened for signature 23 May 1969, 1155 UNTS 331 (entered into force 27 January 1980) [hereinafter *Vienna Convention on Law of Treaties*].

Art 79 of the *CISG* also deals with the circumstances in which the buyer or seller may be excused from performance of his contractual obligations because of an extraneous event. *United Nations Convention on Contracts for the International Sale of Goods,* opened for signature 10 April 1980, 1489 UNTS 3 (entered into force 1 January 1988) [hereinafter *'CISG'*].

international practice. In state contracts, the risk of changing circumstances is naturally higher than that in those ordinary contracts, so it is likely, particularly in sectors vital to national economy, for any philosophy maximising the chance to change to be accepted.

On the other hand, the acceptance of the early arbitrations that *pacta sunt servanda* is a general principle of law was based on insufficient analysis of the function of contracts in various legal systems. It should be noted that in some legal traditions there are still different attitudes to fidelity of contracts. For example, in the Japanese tradition, the surrounding circumstances are important for harmonious continuance of contractual relationship.[101]

Besides, the impact of "soft" or "social" values such as human rights profiles on global commerce and trade has had a negative effect on *pacta sunt servanda* policies.[102] Thus, in recent years there is a trend in international contract law to move away from "a contractual model which is static and 'complete' at the time of conclusion and thus unalterable towards a contractual understanding which is dynamic and therefore unavoidably accepts the interference by the parties or the third parties that they have authorised".[103]

Acquired rights

Another principle that is used to advance the theory of internationalisation is the principle of acquired rights. This is one of the most equivocal concepts of Western law. The early international arbitrations of investment disputes had attributed significance to this, in order to

[101] See Takeyoshi Kawashima, 'The Legal Conscience of Contract in Japan' (1974) 7 *Law in Japan* 1.

[102] Such trend is more apparent in the European Union (EU). The EU has become increasingly concerned with environmental and social aspects related to public contracting. Eg, see Peter Kunzlik, 'Environmental Issues in International Procurement' in Sue Arrowsmith and Arwel Davies (eds), *Public Procurement: Global Revolution* (1998) 199; Christopher McCrudden, 'Social Policy Issues in Public Procurement: a Legal Overview' in Sue Arrowsmith and Arwel Davies (eds), *Public Procurement: Global Revolution* (1998) 219; Kai Krüger, Ruth Nielsen and Niclas Bruun, *European Public Contracts in a Labour Law Perspective* (1998).

[103] Klaus Berger, 'Renegotiation and Adaptation of International Investment Contracts: the Role of Contract Drafters and Arbitrators' (2003) 36 (4) *Vanderbilt Journal of Transnational Law* 1347, 1378.

debar any initiative that might reduce the rights or advantages of investors.[104] However, one must note that the concept of acquired rights is not a universal principle and its meaning and content vary in its historical context. Like all human freedom and rights in municipal legal systems, the degree of inviolability of acquired rights is dependent upon the legal order that promotes or excludes it. The logical problems of accepting the doctrine may be even greater than those relating to the acceptance of the principle of *pacta sunt servanda* partly because it is not widely accepted as *pacta sunt servanda* and partly because it is a mere contractual principle.

The suitability of both principles of *pacta sunt servanda* and acquired rights in the context of state contracts has been debated by many scholars.[105] Maniruzzaman, who studied the different scholarly views regarding the matter, commented,

> "…whatever weight was once attributed to the principles [*pacta sunt servanda* and acquired rights] as the protective shields for foreign investors' interests in the host state seems to have waned to some extent in the face of the well-recognised 'fundamental principle of contemporary international law', i.e. the principle of permanent sovereignty of states over natural resources."[106]

3.3. Summary of Findings

In the foregoing discussion the origin and the development of the theory of internationalisation that supports the applicability of international law to concession contracts has been examined. The purpose and nature of creating the theory of internationalisation were reasonable to bring concessions under supranational regulation and to thereby protect foreign investment from the mass nationalisation process that took place in newly-independent states just after the colonial period. The theory thus grew up and took shape under the conditions of

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[104] Relying on a doctrine of acquired rights binding upon Saudi Arabia, in *Aramco Award* the tribunal found that Aramco was "justified in resisting any infringement of the rights granted to it" 27 ILR 117, 206 (1958). Also see *Liamco Arbitration* 20 ILM 1, 103-104 (1981); *Sapphire Arbitration* 35 ILR 136, 171 (1963).

[105] Brownlie, above n 51, 552; Garcia Amador, *The Emerging International Law of Development* (1990) 123-126; Sornarajah, above n 32, 23-29, 137-143.

[106] Maniruzzaman, above n 38, 317.

nationalisation, when takings of foreign property had reached an extreme point, when foreign investment needed protection.

The earlier international arbitral tribunals had seen international law as a device through which foreign investment protection could be ensured. For them, the exclusion of the application of national laws had become an immediate practical solution. Therefore, internationalisation represented a radical point of departure from classical theories that were accepted in the past according to which, concession agreements were normally governed by the law of the State party to the contract.

In a trilogy of cases in the mid 1950s international arbitral tribunals reversed the long standing tradition of applying the host state's law to concession agreements and held that concessions were subject to general principles of law. Rejecting customary international rules and state practices in this area, the arbitrators had continuously insisted on the subjection of foreign investment contracts to *lex mercatoria* or general principles of law, which existence is doubtful. It is evident from the decisions that the early arbitral awards did not mean that the international law would be applied as a law of contract. It was the policy implications that were reflected in the Sapphire Arbitration and later carried to the Libyan nationalisation of oil concessions- *Texaco*, *BP* and *Liamco* that pushed the idea that public international law is applicable to state contracts.

However, there was no fundamental theory or theories that directly contribute to the idea that international law should govern state contracts. So, the opponents of the theory had resorted to various rules and techniques borrowing them from other fields of law in order to make the application of international law to state contracts acceptable. Yet, the utilisation of legal doctrines and principles of other fields of law had caused more disagreements among legal scholars and within the international community itself.

Firstly, in order to lift concession agreements from the orbit of national legal systems, the early arbitral tribunals had pushed through their awards the idea that concession contracts were either treaties or special arrangements that were subject to some supranational regulation. The opponents of the theory had offered different arguments in support of the correctness of the notion. The assimilation of concession contracts to treaties, the concept quasi-international contracts and 'new law merchant" were all the reflection of the efforts of the arbitral tribunals to internationalise concessions.

In fact, none of the arguments had won acceptance by both scholars and arbitrators. The indications are that old concession contracts as well as their modern ancestors are not treaties, but a species of commercial contracts with a peculiar nature. Such a peculiarity has given it a special character that might justify the relevance of international law or some kind of a new legal order but never can entirely exclude the relevance of the host state's law.

Then, certain contractual clauses were brought to justify the relevance of international law. Choice of law clauses were utilised to make reference to international law as the law applicable, stabilisation clauses were included to freeze the law applicable and arbitration clauses were intended to bring a state party to a neutral tribunal outside its territory. Hence the inclusion of all these clauses in state contracts has, proven to be an ineffective method of externalising the agreement. This is partly because of lack of legal foundations to contest their validity except a prejudice of some arbitrators and partly because of their unsuitability in state contracts. There is greater danger that the clauses can be held unenforceable.

Furthermore, several other rules also extracted as general principles of law and were transferred into the area of law on foreign investment to support international protection of foreign investment. Among them are the doctrine of *pacta sunt servanda* which is said to bind absolutely a state by its promises made in contract and the doctrine of acquired rights which

ensures protection of property rights vested in foreign party as a result of contracts it was entered with a state. The application of these principles to state contracts has faced however, a number of problems opposing such application. As one scholar observed:

> "A blind insistence on the application of *pacta sunt servanda* to such transnational [concession] contracts betrays a lack of a sophisticated appreciation of the nature and origin of such transactions, the inherent instability in such long-term arrangements and the formidable difficulties posed by their administration".[107]

Given this evidence, it can be seen that the theory of internationalisation is an artificial doctrine deliberately intended to create a new regime that protects foreign investors and their property as response to the mass nationalisations made by newly independent states in 1950s and 1960s. It would be time to recognise this fact and redevelop legal rules and principles that maintain a fair contractual balance considering the framework of new rules and principles applicable in the arena of development. Importantly, it is advisable that the public features of foreign investment agreements that had been ignored by the international arbitrators are accepted.

The repetitious arbitral practices and their confirmation by the international instrument could not settle many controversies in the theory of internationalisation. Despite the claims of internationalists for the application of international law to the concerning agreements, there has been a number of theoretical and practical obstacles which confront such application.[108] These obstacles and contradictions further have weakened the strength of the theory of internationalisation, and they should be investigated.

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[107] Samuel Asante, 'Stability of Contractual Relations in the Transnational Investment Process' (1979) 28 *International and Comparative Law Quarterly* 401, 407.

[108] As stated by Maniruzzaman, "traditional international law has not changed a great deal, and the theoretical and practical objections to its application to state contracts still prove to be cogent". Maniruzzaman, above 49, 12.

CHAPTER FOUR: CONTROVERSIES IN THE THEORY OF INTERNATIONALISATION

4.1. Controversies Related to Public International Law

The theory of internationalisation of state contracts has raised a great deal controversy as it attempted to regulate contracts between states and private persons by public international law. Most scholars have considered this to be impossible because of the nature of international law. Especially for positive international lawyers, such an application was doomed to be a daunting and frustrating exercise. As one scholar put it,

> "An attempt at applying international law to private relations would be tantamount to seeking to apply the matrimonial laws of France or England to relations between cats and dogs".[109]

The arguments opposing the application of public international law must to be discussed.

4.1.1. THE QUESTION OF INTERNATIONAL LEGAL PERSONALITY OF MULTINATIONALS

The first greatest theoretical argument confronted the application of international law to state contracts was the traditional positivist notion which holds that only States are subjects of international law. Until the late 1950s this view was the dominant one. As Kahn states, public international law is designed to govern relations between States and, if necessary, between States and international organisations, not to govern juridical relations involving private persons.[110]

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[109] Angelo Sereni, 'International Economic Institutions and the Municipal Law of States' (1959) 96 (1) *Recueil des Cours* 129, 210.

[110] Kahn, above n 47, 16.

However, one of the changes in international law that has been raised in the second half of the twentieth century dealt primarily with the status of individuals in international law. International protection of certain minorities[111] and human rights has led to the granting of limited legal capacity to groups and individuals. Then, the adoption of fundamental human rights by the *UN Charter 1945* made a great contribution towards the development of humanitarian international law which allowed capacity to individuals to claim respect for rights granted to them against their own governments before international commissions or tribunals.

In the field of international relations, international non-governmental organisations (NGOs) formed by individuals and associations have played a major role in seeking basic rights for people and improving their conditions. Because of the undeniable influence of international NGOs in world affairs scholars begun to speak about the limited legal capacity of NGOs in the international arena where previously only states were granted a full legal capacity. However, the legal status of NGOs under international law is granted on the legal basis just in 1991, when the *European Convention on the Recognition of the Legal Personality of International Non-Governmental Organizations*[112] came into force.

Today, the number of internationally operated NGOs has reached six thousand.[113] These organisations – which often are referred as to "non-state actors" suggesting their legal capacity - have become the most effective voices for the concerns of ordinary people in the international policy arena**.** Apart from traditional human rights concerns, modern NGOs address a number of other social, economic and political activities of communities and the country as a whole such as promotion of economic development, improvement of health care and prevention of

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[111] At the end of World War One, several treaties were concluded for purpose of providing special protection for minorities. See A H Robertson, *Human Rights in the World* (1972) 20-22.

[112] *European Convention on the Recognition of the Legal Personality of International Non-Governmental Organizations,* opened for signature 24 April 1986, 24/IV/1986 ETS 124 (entered into force 1 January 1991).

[113] Michael Williams, *Global Civil Society: Expectations, Capacities and the Accountability of International NGOs* (2003) 21st Century Trust < http://www.21stcenturytrust.org/williams2.html > at 27 September 2007.

environmental degradation. The most well-known organisations are Oxfam, the International Committee of the Red Cross, CARE, Doctors without Borders, Amnesty International and Greenpeace.

Indeed, the fact that private individuals either themselves or through the creation of associations or some voluntary organisations like NGOs can bring their concerns on the international level has served the foundations of the theory of limited legal personality of international law. Under the theory, some members of international society may be given a certain standing and certain recognised capacities, but their standing or capacities are restricted only within that field of international activity where they are a subject of legal rights and obligations. For example, insurgents claiming for independent status of their country can be granted a legal personality in the field of international human rights law.

In this sense, the procedural capacity of a private partner or corporation to bring its dispute before an international tribunal has become a decisive factor for the recognition of legal personality of investors in the area of international investments. Lauterpacht, who first radically opposed the idea of the early positivists, commented that there is no principle in international law, which 'prevents States, if they so wish, from securing to individuals …access to international courts and tribunals'.[114] Also, one of the main representatives of the theory, Kelsen, stated 'individuals can have international rights only if there is an international court before which they can appear as plaintiffs'.[115]

Therefore, international investment arbitration tribunals set up by a multilateral agreement, such as the ICSID tribunal, consecrate the capacity for direct action of investors

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[114] Hersch Lauterpacht, 'The Subjects of the Law of Nations' (1947) 63 *Law Quarterly Review* 438, 451.

[115] Hans Kelsen, *Pure Theory of Law* (1967) 347.

This view came about after World War One when the peace treaties provided that the subjects of allied powers could claim reparations in mixed arbitral tribunals.

against host states. This capacity for action was further increased as many international investment protection treaties started to contain similar provisions confirming the capacity of individuals for bringing the state before an arbitration panel. Under these circumstances, hardly any contemporary international lawyer would deny the international legal personality of transnational corporations in the international arena.[116]

However, as far as the legal capacity of foreign investors under international law is concerned, one must note that there still exists some uncertainty and ambiguity. First, it is doubtful whether one could go as far as to accept the international legal personality of individual private investors. In domestic jurisdictions, companies are regarded as a juridical person that is distinct from its shareholding members and has a legal capacity to manage its own affairs. The shareholders are usually not able to pursue legal rights owned by the company. International practice departed from the general rule of distinguishing between the corporation and its shareholders. More specifically, in the *ELSI* case shareholders were afforded protection as to the rights of control, management, use and dispose of their property, that is, of their local subsidiary.[117]

Besides, the question of legal personality of multinationals or foreign investors may attract some criticism. In a technical sense, the legal status describes a position of a particular actor having both rights and obligations in the legal system. Today, multinational companies enjoy extensive international rights and protection because of the adoption of the theory of

[116] Some scholars however may still oppose such assumption. Lillich for example, asserted that the fact that certain rules of international law provide direct rights and obligations for the individual is still a limited exception rather than a general rule. See Richard Lillich, 'The Law Governing Disputes under Economic Development Agreements: Re-examining in the Concept of Internationalization' in Richard Lillich and Charles Brower (eds), *International Arbitration in the 21st Century: Towards `Judicialization' and Uniformity?* (1994) 61, 68-69. Also see Georges Abi-Saab, 'The International Law of Multinational Corporations : A Critique of American Legal Doctrines' in Frederick Snyder and Surakiart Sathirathai (eds), *The Third World Attitudes Towards International Law: An Introduction* (1987) 549, 553.

[117] *Elettronica Sicula SpA (ELSI) (United States v Italy)* [1989] ICJ Rep 15.

internationalisation. But as regards duties, there have been not many obligations prescribed on the activities of multinationals,[118] despite the fact that environmental, labour and human rights abuses have been committed by, or through the complicity of foreign investment enterprises operating in the developing world. [119] Thus, it would be illogical to argue for multinationals' international legal personality if they do not accept correlative duties on the international plane.

4.1.2. THE RELEVANCE OF PUBLIC INTERNATIONAL LAW TO PRIVATE CONTRACT

The next theoretical difficulty of applying international law to investment agreements has been the absence of any legal ties between a private contract and public international law. From the positivist standpoint, public international law does not govern contractual relationships and it purports only to control relations between States or between States and intergovernmental organisations. This view is best observed by the words of Judge Jessup,

> "Since the cases [before the Mixed Arbitral Tribunals established under the peace treaties at the end of World War I] …were not international in the sense of being state v state, public international law, or what the Permanent Court called true international law, was not considered generally applicable except for the purpose of interpreting treaties. The Tribunals, therefore, while resorting in some cases to private international law and to national laws, frequently fell back on general principles of law and equity."[120]

On the other hand, to be legally enforceable, every contract has to belong to a certain legal order which provides security and legal recognition to it. The idea that every contract has to

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[118] It is often commented that multinational and bilateral investment treaties are too one-sided dealing mainly with investment protection and disregarding environmental and social responsibilities of foreign investors. A series of codes of corporate conduct such as the *OECD Guidelines for Multinational Enterprises* or the *United Nations Global Compact* and instruments developed by industry-controlled organizations such as the *Global Sullivan Principles* and the *Social Accountability 8000 Standard* do not create legal obligations.

[119] NGOs play a central role by calling attention to abusive labour practices, environmental offences, and marketing of products that are known health-hazards. For more see Christiana Ochoa, 'Advancing the Language of Human Rights in a Global Economic Order: An Analysis of a Discourse'(2003) 23 *Boston College Third World Law Journal* 57.

[120] Philip Jessup, *Transnational Law* (1956) 95-96.

be founded in some legal order is a traditional one. The best expression of the idea may be found in Lord Diplock's following statements:

> "[C]ontracts are incapable of existing in a legal vacuum. They are mere pieces of paper devoid of all legal effect unless they were made by reference to some system of private law which the obligations assumed by the parties to the contract by their use of particular forms of words and prescribe the remedies enforceable in a court of justice for failure to perform any of those obligations."[121]

That legal system ensures mechanisms to rebuild the lost rights of one party, when the other party fails to perform the obligations under the contract. At a national level, municipal law guarantees parties to make their agreement a valid, binding and enforceable obligation through sanctions established by the law concerned. But international law lacks such sanctions that could enforce contractual arrangements made between a State and a foreign party.[122] There are a few sanctions in international law such as reprisal and retorsion which apply only in the case of international responsibility of a State as an act perpetrated by one nation upon another.[123] This means that international law is not the legal order or system from which the binding nature of the contract stems.

Leaving the theoretical aspects aside for a moment, it is as a practical matter difficult to apply international law to investment agreements due to the absence of substantive rules in its context. Jurists and scholars often acknowledge the fact that public international law lacks the detailed contractual rules suitable for application to foreign investment contracts.[124] Kahn argued

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[121] *Amin Rasheed Shipping Corporation v Kuwait Insurance Co* [1983] 3 WLR 241, 249-250.

[122] Prof Jennings admitted: "The classical law was incapable of providing any remedy other than a remedy for delict. So the argument under discussion is thus far not merely correct; it is truism." Jennings, above n 29, 164.

[123] The most widespread sanction of international law, economic sanctions, are now under attack from human rights organisations.

[124] Christopher Greenwood, 'State Contracts in International Law - The Libyan Oil Arbitration' (1982) 53 *British Year Book of International Law* 27, 61 and 64; A A Fatouros, 'International Law and the Internationalised Contract' (1980) 74 *American Journal of International Law* 134, 136.

"it [public international law] is poorly adapted to the role it is asked to play in investments; it has many lacunae and investment agreements were not a consideration in its evolution. [125]

Another practical objection against the applicability of international law is the fact that foreign investment contracts have more contacts to national law than to international law. It was suggested that the possibility of complete internationalisation of the contracts by referring exclusively to international law is not advisable because of the contacts of the investment activity to various technical provisions of the host state's law.[126]

On the other hand, nowadays foreign investment as a tool to implement economic development programmes has been increasingly viewed as a matter of national policy of developing states. This has led to the construction of national legal rules and norms by developing states to control the investment activities carried on their respective territories.[127] Then, being a part of public policy, the most rules adopted in the field of foreign investment independently apply to foreign investment agreements concluded by the state with a private foreign party. Finally, due to the overwhelming view that investment agreements are not treaties there is strong juristic support for the view that a breach of contract by the State party does not constitute international responsibility.[128] As a result, one cannot enforce contractual obligations by international law.

4.1.3. ADVOCATING A MONIST APPROACH

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[125] Kahn, above n 47, 17.

[126] Christoph Schreuer, *The ICSID Convention: A Commentary* (2001) 563.

[127] As Delaume observed, "Recent years have witnessed a determination on the part of a number of states to relocalise state contracts under the aegis of their own legal system." Georges Delaume, 'Proper Law of State Contracts Revisited' (1997) 12 *ICSID Review* – Foreign *Investment Law Journal* 1, 11-12.

[128] Jennings and Watts wrote: "It is doubtful whether a breach by a State of its contractual obligations with aliens constitutes per se a breach of an international obligation, unless there is some such additional element as denial of justice, or expropriation, or breach of treaty, in which case it is that additional element which will constitute the basis for the State's international responsibility." See Robert Jennings and Arthur Watts, *Oppenheim's International Law* (9th ed, 1992) 929.

The issue on the relationship between international law and municipal law is itself very controversial one. Two opposing theories have been competing for acceptance, monism and dualism. Monists assert that there is only one legal order, of which both international and national law are part, and that therefore either national or international courts or arbitral tribunals can apply international law directly without any transformation at the national law level.

Dualists, on the other hand, argue that there are two essentially different legal systems. They exist side by side within different domains - the international domain and the domestic domain. Therefore, international law needs be first transformed into national law by means of some legislative devices at the national law level before it can be regarded as valid applicable rules.

Historically, the dualist concept of international law prevailed in the practice of most states dominating throughout the centuries. That is because the dualistic vision was based on legal positivism and was consistent with the fundamental principles of international law such as state sovereignty and territoriality. State sovereignty is an ambitious concept in international law and it keeps relations between individuals and groups in the sphere of individual autonomy of a particular state not letting supranational governance to rule them.

On the contrary, the monist vision of the relationship between international law and domestic law is a relatively recent phenomenon which has emerged as a result of the increasing influence of international law upon the municipal legal system, especially the influence of international human rights norms since the end of the World War Two. However, because of new developments created by globalisation, the strict substantive separation of domestic and international law as postulated by traditional dualism is becoming more and more plausible, and there is a increasing influence of international law on decisions of national courts.[129]

[129] Kirby J pointed out that there has been a gradual erosion of the strict theory of dualism even in common law countries such as England, Australia and New Zealand, which used to adhere scrupulously to dualism. Michael

But the current changes in international law and its strong influences over domestic law do not mean that dualism is giving way to monism. Since the debate on the interrelation of international and domestic law has not been settled at a universal level, it seems impossible to draw a conclusion whether monism or dualism prevails in the modern international legal order. In a great majority of the states, there is still adherence to dualism.

Practically, international law and treaty rules have no direct effect in municipal law.[130] According to generally accepted rules in the state practice with respect to issue of interrelation of national and international law, a few rules that apply directly are ones known as mandatory rules of international law or as *jus cogens.* [131] All other international rules have to be transformed into national law to be obeyed by the state concerned. And the provisions of national law cannot prevail over those of treaties, to which the state is a contracting party.[132]

National courts disregard international rules, if they find that those rules are not adopted by the country concerned. Even international rules and principles approved by states may be violated because there no central organ or law-enforcing authority in international community to enforce those rules. Under the international legal principle of non-intervention in the internal affairs of states, it is usual for sovereign states to deny individuals' rights and privileges provided by international human rights instruments.[133]

Kirby, 'The Impact of International Human rights Norms: A Law Undergoing Evolution' (1995) 25 *Western Australian Law Review* 1.

[130] But some states, by virtue of their membership of supranational bodies, allow the direct incorporation of rights or enact legislation to honour their international commitments. For example, decrees and rules adopted by the EU may be directly applicable to all member states.

[131] *Vienna Convention on Law of Treaties* used *jus cogens* and peremptory norms interchangeably. According to it, a peremptory norm of general international law is a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character (Art 53).

[132] *The Greco-Bulgarian Case* (1930) PCIJ (ser B) No 17.

[133] For example, the Chinese government broke up democratic activity with troops killing hundreds of students. For more about the event see, Daniel Schugurensky, *Selected Moments of the 20th Century* (2001) the Ontario Institute for Studies in Education of the University of Toronto (OISE/UT) <http://fcis.oise.utoronto.ca/~daniel_schugurensky/assignment1/1989tiananmen.html> at 27 August 2004.

From this angle, monism and dualism is a matter of consent of the state in the question. The acceptance of treaty rules of international law by its subject, ie by states depends upon the consent of those states. Fortunately, most national constitutions define its openness or closeness to international law. Particularly, the *Norwegian Constitution* provides,

> "Treaties on matters of special importance, and, in all cases, treaties whose implementation, according to the Constitution, necessitates a new law or a decision by the Parliament, are not binding until the Parliament has given its consent thereto."[134]

In the context of the theory of internationalisation, ICSID arbitral tribunals however have taken a different position contrary to the international practice. The proponents of the theory had rested on the strict monist angle that superimposes international law on municipal law.[135] Arguing in the monistic tone, Judge Lauterpacht observed that subjecting an international contract to some municipal law does not necessarily mean that the municipal law is '…a matter which is wholly outside the orbit of international law'. As he commented,

> "It is not enough for a State to bring a matter under the protective umbrella of its legislation… in order to shelter it effectively from any control by international law."[136]

Lauterpacht's monist approach since has been adopted by international arbitral tribunals. In many cases the tribunals gave priority to international law in the case of inconsistencies between these laws declaring that international law is an integral part of municipal law without questioning whether the rules concerned are *jus cogens* or not. Specifically, in *SPP v Egypt* the tribunal held,

> "We find that reference to Egyptian law must be construed so as to include such principles of international law as may be applicable and that national laws of Egypt can be relied upon only in as much as they do not contravene said principles."[137]

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[134] *Norwegian Constitution* (1814), Art 26 (2).

[135] Schwebel noted, "… it appears to be assumed that international arbitral tribunals, including those sitting between States and aliens, are 'monist' rather than 'dualist' in the place they accord to international law". Schwebel, above n 36, 140.

[136] *Certain Norwegian Loans (France v Norway)* [1957] ICJ Rep 9, 37.

The controversial position with respect to the relationship between international law and domestic law has become one of the weaknesses of the theory of internationalisation. The theory implies that international law applies as the overriding governing law even in situations where foreign investments were not made subject to international law. Particularly, it has been suggested that notwithstanding the silence of the agreement on the question of the applicability of international law, the arbitral tribunal dealing with issues of investment protection should call on the principles of international law to save investors from injury.[138]

In practice, it is important to establish whether the country concerned is monist or dualist in its approach. There is a possibility that an award of the tribunals could be resisted in a country which has a dualist system such as Mongolia.[139] Courts of Mongolia would refuse an award of tribunals, if they find that the award is based on provisions of a treaty which is ratified by the parliament but incompatible with the *Constitution* of the state.

4.2. Controversies Related to Private International Law

The fundamental rules of conflict of laws also have been twisted to some extent in the face of principles supporting the theory of internationalisation of state contracts. First of all, the dichotomy of public and private law has become irrelevant in case of state contracts. Though earlier advocates of the theory of internationalisation had accepted the principle of party autonomy which is a basic rule of conflict of laws, they did not apply the principle in its traditional sense. The problems of the theory of internationalisation arising in the field of private international law must be examined in turn.

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[137] *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt* (ICC Award) (11 March 1983), 3 ICSID Reports 46, 65.

[138] Masood, above n 41, 319.

[139] Art 10 (3), (4) of the *Constitution of Mongolia* of 1992 declares:

> "The international treaties, to which Mongolia is a Party, shall become effective as domestic legislation upon the entry into force of the laws on their ratification or accession. Mongolia shall not abide by any international treaty or other instruments incompatible with its Constitution."

4.2.1. BLURRING THE PUBLIC/PRIVATE DIVIDE IN LAW

Basically, in all jurisdictions law is divided into two aspects, public and private.[140] The first group comprises all regulations that directly affect society as a whole. They are enforced by the authorities by means of fines, penalties or withdrawal of licenses. As a general rule, matters governed by public law are beyond the pale of choice of law, since the rules of public law apply irrespective of private choice of law. Parties to contracts cannot simply exclude, alter or limit these rules.

The second group of laws makes up private law branches which directly affect the legal relations between individuals, families, or small groups dealing with their contractual and non-contractual issues. Naturally, a majority of rules of private law (*ius dispositum*) is applied when the parties have expressed their intention to regulate a given situation. Thus, only these rules are the subject matter of private international law or conflict of laws, which deals with the differences between the municipal laws of different countries.[141]

Nevertheless, a series of oil-related arbitration cases of 1950s involving the question of state expropriation and national land use rights broke with this tradition of public/private divide in law and pushed the notion of party autonomy into the domain of public law. In the support of their decisions, these arbitral tribunals had relied on the same justifications that support autonomy in private law matters.[142] Therefore, the traditions of public rights and sovereign regulatory authority that always have been the legitimating standard for interference with private

[140] This traditional widespread belief of continental legal systems continues to be of a great importance as legal theorists often rely on it in their new approaches to legal issues.

Daniela Caruso stated: "… the obsolete public/private distinction, rather than simply ruling European scholars from its grave, is forever reincarnated in new forms and never fails to shape legal theory and practice. Daniela Caruso, 'The Missing View of Cathedral: The Private Law Paradigm of European Legal Integration' *(*1997) 3 (1) *European Law Journal* 3, 8.

[141] In this context the public/private divide has served an important purpose within the Continental European tradition in insulating private international law from political concerns. This is less true in the US, where the relationship between law and politics has been monitored by comity in the international arena. See Joel Paul, 'Comity in International Law' (1991) 32 *Harvard International Law Journal* 1.

[142] See, eg, *Sapphire Arbitration* 35 ILR 136 (1963).

rights in national contract laws have been neglected by the international law on foreign investment ever since.[143]

State contracts belong to a category of legal relationships, where principles of commercial law interact with notions of public law and public international law.[144] On the one hand, because of their financial character, state contracts are a type of commercial contract, which logically would be founded on the private law notions of commercial contracts. On the other hand, it is equally logical to subject them to public law since the presence of a state and the public interest element require the contract to be flexible, meeting the requirements of the changing administrative regulations and public policies of the state.[145]

As a consequence of the mixed private/ public law nature of foreign investment contracts, the discussion on choice of law issues relating to investment disputes should involve the application of both the private and public law of countries. However, international arbitrators supporting the theory of internationalisation had made no distinction between matters where the parties' choice can be validated and matters where the law applies regardless of any choice made. What they had tried was to show that all matters of investment disputes were subject to the chosen law which is most likely international law.

Furthermore, the opponents of the theory of internationalisation had supported the inclusion of the choice of law clause in foreign investment contracts in order to make the direct

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[143] See Ch Five, Section 5.2 – Sources of International Law on Foreign Investment. It shows that rules of international law developed in the context of internationalisation of state contracts were intended to reduce the regulatory controls of the host state over foreign corporations' operations.

[144] As Trachtman wrote, international commercial law straddles any gap between the two types of international law, because it "regulates both private persons and states." See Joel Trachtman, 'The International Economic Law Revolution' (1996) 17 *University of Pennsylvania Journal of International Economic Law* 33, 35.

[145] Campbell rightly observed that:

> "Those who enter into agreements with governments and governmental agencies are always at risk that the performance of the agreement may be rendered wholly or partially impossible by either supervening legislation or by action taken by the governmental party or another governmental party in the exercise of a statutory power. The exercise of statutory powers is not inhibited in any way by the prior existence of contractual arrangements which might be detrimentally affected if those statutory powers were to be exercised". Campbell, above n 68, 144.

reference to international law as the governing law of contract. But the mission is eroded by the fact that public international law does not have any substantive rules applicable to contracts except for some general treaty rules.[146] On the other hand, as a general principle, the treaty rules apply automatically without being chosen by parties as the governing law of the contract. Thus the internationalisation theory also confused the domains of public and private international law.

In fact, traditional limitations imposed on conflict of law rules are greater in the case of state contracts due to the substantial public interest involved in the contracts. Recently, it has become common for arbitrators to deal with public interest issues, as economic development has been viewed exclusively as a matter of public policy. Drawing the line between public and private law can define the scope of economic regulation which comes within the sphere of public policy. Thus, the public/private distinction should be reinforced in the international economic system.

4.2.2. CHANGING THE TRADITION OF THE PARTY AUTONOMY PRINCIPLE

One of the basic theses with which supporters of applicability of international law to the contractual relationships began is the principle of private international law that permits parties to international contracts to choose the law of their contract. It has been claimed that since the principle is universally accepted in international business parties to state contracts also should be granted it. As Mann argued,

> "…by exercising their rights to choose the applicable legal system the parties may make public international law the object of their choice… that fact that one party is not a State should not prevent the contract from being submitted to public international law…. it is their will, their choice, founded upon and permitted by the private international law of the forum, that may submit a contract to the law of States, to public international law".[147]

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[146] Sornarajah wrote:

> "The choice of international law may be possible but the theoretical difficulty is that … there is no body of international law applicable to contracts between states and foreign private entities". Sornarajah, above n 1, 411.

[147] F A Mann, 'The Theoretical Approach Towards the Law Governing Contracts between States and Private Persons' (1975) 11 *Revue Belge de Droit International* 562, 586.

Looked at from the standpoint of private international law, once the parties to international contracts have chosen a particular law as the applicable law, the choice of law should be strictly observed. Except for certain mandatory rules from which there is no escape, there is nothing that subverts or modifies the choice. In general, traditional rules of private international law knew only such limitations as can be justified for the protection of weaker parties or genuine state interests.

However, the early *ad hoc* arbitrations that gave birth to the theory of internationalisation had violated the tradition of party autonomy. They meant that a state contract will always be subject to international law despite any municipal law being chosen by the contracting parties as the sole proper law of the contract. The arbitrations involved in the building up of this rule may be briefly examined.

It was the *Aramco* arbitration that first eroded the parties' express stipulations. Despite the article in the concession agreement stating that, in case of dispute, the Muslim law as taught by the Hanbali School would be applicable, the arbitrators held that even though parties have agreed to the application of a particular law, the law which a reasonable man would purport to apply, should be the law applicable. Thus, the arbitrators came to the conclusion that the contract could not be governed by national law alone because of its "*sui generis*"[148] character and "because of its parties and of its ramifications, an international character"[149]

Then, the Libyan nationalisation cases- *Texaco*, *BP* and *Liamco* made a clear departure from traditional choice of law. All three concessions had a choice of law clause which reads as follows:

> "This concession shall be governed by and interpreted in accordance with the principles of law of Libya common to the principles and rules of international law and in the

[148] *Aramco Arbitration* 27 ILR 164 (1958).

[149] Ibid, 166.

> absence of such common principles of law, then by and in accordance with the general principles of law, including such of those principles as may have been applied by international tribunals."[150]

In the *Liamco* and *BP Arbitration,* arbitrators interpreted the meaning of this provision that both systems are applicable and if there is inconsistency, then the general principles of law should prevail.[151] Especially, in the *Texaco Case*, Prof Dupuy, the sole arbitrator reached the decision not on the basis of the choice of law clause, but rather he relied on the view that foreign investment contracts are better be governed by public international law. He stated:

> "…treaties are not only type of agreements governed by international law… contracts between states and private persons, under certain conditions, come within the ambit of a particular and a new branch of international law: the international law of contracts". [152]

The most categorical and explicit pronouncement on the rejection of party autonomy in the field of law on foreign investment comes from the *CMI* case, where the Iran-United States Claims Tribunal disregarded the parties' choice of law on several occasions and applied a-national rules or general principles of law.[153] Here, the arbitrators based their justification for overriding parties' choice on the Claims Settlement Declaration (CSD). The declaration provided the tribunal with a broad discretion in its choices of applicable law by virtue of which it was possible to disregard the parties' choice.[154]

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[150] This is modified version which was amended on 20 January 1966, after the enactment of the ICSID Convention. Clause 28 (7) of the original concession agreement dated on 12 December 1955 contained a provision which reads as follows:

"This concession shall be governed by and interpreted in accordance with the Laws of Libya and such principles and rules of international law as may be relevant, and the umpire or sole arbitrator shall base his award upon these laws, principles and rules."

[151] Georges Delaume, *Law and Practice of Transnational Contracts* (1988) 19.

[152] *Texaco Award* 53 ILR 309 (1977), para 32.

[153] For example, the tribunal stated that it 'prefers to analyse the damage questions in accordance with general principles of law', rather than by reference to the law chosen by the parties in the particular case. See *CMI International Inc v Iran-US CTR* (1983 III) 263 et seq., 268.

[154] Art V of the CSD provides that:

"The tribunal shall decide all cases on the basis of respect for law, applying such choice of law rules and principles of commercial and international law as the Tribunal determines to be applicable, taking into account relevant

The tribunals' approach to apply international law regardless of parties' choice has been adopted by some international instruments. Particularly, by virtue of Article 17 (2) of the 1998 *ICC Rules of Arbitration*, the ICC Tribunal is authorized in all cases, whether in the case of an express choice of law or in the absence of it, to take account of the relevant trade usages. This suggests that if the parties' chosen law is inconsistent with relevant trade usages, the latter may override the chosen law to the extent of its inconsistency. However, research has not found an exact case in which parties' chosen law is overridden because of its inconsistency with the relevant trade usages.

Another example of the approach is found in the *North American Free Trade Agreement (NAFTA)*[155] and the *Energy Charter (ECT)*[156], where the arbitral tribunals are authorized to decide the issues in dispute in accordance with relevant treaty provisions and applicable rules and principles of international law directly binding Party Governments by international law standards. Since both treaties did not provide for parties autonomy to select the governing law of their agreement no matter what the parties may expressly choose to the contrary in their investment contracts. In this regard, the application of national law or anything else that the parties may have agreed to be applicable is controlled by the aforesaid standards provided in the treaties.[157]

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usages of the trade, contract provisions and changed circumstances." See George Aldrich, the *Jurisprudence of the Iran-United States Claims Tribunal: An Analysis of the Decisions of the Tribunal* (1996) 156-170.

[155] *North American Free Trade Agreement between the Government of Canada, the Government of the United Mexican States and the Government of the United States of America*, opened for signature 17 December 1992, 32 ILM 296 (1993) (entered into force 1 January 1994). Art 1131, entitled 'Governing Law', provides as follows:

1. A Tribunal established under this Section shall decide the issues in dispute in accordance with this Agreement and applicable rules of international law.

[156] *Energy Charter Treaty*, opened for signature 17 December 1994, 33 ILM 360 (entered into force 16 April 1998). Art 26 (6) reads as follows:

A tribunal established under paragraph (4) shall decide the issues in dispute in accordance with this Treaty and applicable rules and principles of international law.

[157] See Thomas Waelde, 'Investment Arbitration under the Energy Charter Treaty-From Dispute Settlement to Treaty Implementation' (1996) 12 *Arbitration International* 429, 457-458; Andrew Tucker, 'The Energy Charter

4.3. Summary of Findings

The analysis within this chapter (*Chapter Four)* illustrates the theoretical controversies surrounding the theory of internationalisation of state contracts. The theory has triggered off the burning controversy as to the very nature and also the extent of the application of both public and private international law. By providing private actors with international personality and attempting to regulate of internal affairs of sovereign states by international law the theory had contradicted the historical definition that international law is 'the rules which determine the conduct of sovereign states in their dealings with each other'.

In fact, multinationals have increasing international rights and the capacity to sue states which may accommodate them as the limited subjects of international law, it is still illogical, unconventional and dangerous to permit multinationals to act in the international plane independently as states. Notwithstanding the extent to which multinationals have been given the extensive rights and protection under international law, they must not be able to avoid the application of national legal systems in whose territory they carry out their business and should remain subjects of those municipal systems.

At the same time, selecting international law as the proper law of a contract seems to be the least bad option for a private party who wants to obtain a contractual remedy, when national contract law or private international law can give a better guarantee. Principally, international law can or should be pleaded by foreign investors only in circumstances where their basic human rights are violated or they are mistreated. That is the area where international law operates and applies regardless of parties' choice. Furthermore, the issue of hierarchy or combination of international law and national law is a controversial one. Generally, only mandatory rules of international law can superimpose national law; other rules have no effect

Treaty and "Compulsory" International State/Investor Arbitration' *(*1998) 11 *Leiden Journal of International Law* 513, 524-525.

unless they are approved by a State concerned. On the other hand, the issue depends on the nature of dispute concerned and the position of a country concerned in relation to monism and dualism.

The second part of *Chapter Four* was devoted to a discussion of problems and controversies raised by the theory of internationalisation in relation to private international law. First of all, it mixed up the traditional function of conflict of law rules blurring the traditional public/private distinction in law. Historically, conflict of law rules applied only to optional rules of law but not mandatory. Thus the application of party autonomy to public international law is inconsistent with any system of conflict of law that permits only the choice of private law.

In addition, although party autonomy gave rise to the idea of internationalised concession contracts, the theory of internationalisation actually did not intend to accept the principle as such. A trend superimposing international law over the freedom of parties had arisen in arbitral practice of *ad hoc* arbitrations existed prior to setting up of the International Centre for the settlement of investment Disputes under the ICSID. The arbitrators had striven to give credibility to the view that the parties' choice of municipal law is valid only when it did not contradict with rules of international law they found applicable. It was somehow new to the traditional function of party autonomy.

On this basis it may be inferred that the theory of internationalisation of state contracts has many defects that weaken its strength and validity. In the course of more than 50 years since the decisions of the early arbitral tribunals, the development of the theory of internationalisation has been promoted by arbitral decisions and scholarly contributions; however, it also has been the subject of sharp criticism by other scholars. It is noteworthy that the initial aim of this theory to completely detach state contracts from its municipal law has never been achieved and probably never will.

Part Four: THE LEGAL SOURCES OF INTERNATIONAL INVESTMENT LAW – A DUALITY APPROACH

After World War Two there was a fundamental shift in power from Western Europe and the British Empire to the new superpowers, the United States and the Soviet Union. At the same time, dozens of European colonies in the continents of Asia and Africa freed themselves from the grip of colonialism and gained the capacity to participate in the international system. From this perspective, after World War II, the world split into three competing blocs: the Western camp (often referred to as the "First World"), the socialist or Soviet bloc (referred to as the "Second World"), and the remaining three-quarters of the world's population, the states not aligned with either bloc which were regarded as the "Third World". Since the socialist bloc collapsed, the world today is divided into two essential blocs; The North including Western Europe, North America, Japan, Australia and the South which itself divides into to two subblocs; developing countries and least developed countries.[1]

The emergence of different groups of states with very different social, economic and cultural backgrounds in the international arena laid the seeds of political crisis among them. Each bloc was constantly engaged in the political task of defending its economic independence, advantage, and freedom of action, and thus conflicts of interests arose. Especially, in the field of foreign investment, the North-South conflict has been so sharp causing the development of conflicting principles and approaches. Even an advocate of arbitration conceded that "… the

[1] Special attention to what were then called the less developed countries among the developing countries began at the first Session of UNCTAD in 1964. The first resolution on the subject of the "Least Developed Countries" (LDCs) was adopted at UNCTAD II in 1968. Fifty countries are currently designated by the United Nations as "least developed countries". See UNCTAD, *The Least Developed Countries Report* (2007).

principles established by capital-exporting countries are often pure and simple reproductions of the demands of private investors and are not accepted by the capital-importing states".[2]

The current Part of this thesis intends to investigate the scope of international law applicable to foreign investment disputes. It argues that, because of the existence of politically sensitive state interests in the outcome of disputes in the field of economic regulation over the years following the World War Two, two different approaches have emerged for regulating foreign investment. *Chapter Five* shows the perspectives of each bloc of countries. Then it examines the sources of international investment law within the confines of the theory of internationalisation. It points out that the rules aiming at the creation of an international regime for investment protection have caused the exclusion of other interests involved in that process.

In *Chapter Six*, discussion moves forward to identify a number of opposing norms which emerge from efforts of developing states and the international human rights community to create a more just international economic order. It will be seen that these norms, which were mostly reflected in various UN Resolutions, have contributed to the evolution of the law of economic development.

CHAPTER FIVE: INTERNATIONAL LAW PROTECTING FOREIGN INVESTMENT

5.1. International Law from a North-South Perspective

Since the breakdown of colonialism, foreign investment has become one of the most controversial political and legal issues. Western governments sought a favourable climate for their firms with direct foreign investments outside the Western hemisphere, pushing trade and investment liberalisation policies. On contrary, though socialist countries and third world

[2] Philippe Kahn, 'Law Applicable to State Contracts: The Contribution of the World Bank Convention' (1968) 44 *Indiana Law Journal* 1, 20.

countries needed capital and technology to promote growth, they were more interested in formulating rules reinforcing their sovereignty than in policies restricting it.

Therefore, it is not only useful and also imperative to consider the development of international rules concerning the foreign investment from this political perspective.

5.1.1. PERSPECTIVES OF DEVELOPED STATES

As discussed previously, with the independence of former colonized territories, Western states were threatened by the loss of capital.[3] The revolutionary changes that took place in newly-independent countries including a string of nationalisations increased political and legal hazards of foreign investment. Meantime, the 1962 UN General Assembly *"Resolution on Permanent Sovereignty over Natural Resources"* further eroded economic interests of overseas investors.[4] Therefore, it was significant for capital-exporting industrial states to devise investor-friendly legal structures.

For this purpose, they have strongly supported the applicability of international law in a new context. The content and the nature of international law on foreign investment constructed by industrialised states were reflected in the theory of internationalisation of foreign investment contracts. It was founded primarily on the view that a breach of a foreign investment contract is an international wrong. The second argument of the theory was an idea that foreign investors are disadvantaged, thus they should be protected.

With these objectives in mind, the developed states have attempted to adopt substantive rules on foreign investment protection through arbitral practices and treaty negotiations. In fact, most of the international law rules relating to foreign investment were formulated by awards of

[3] See discussions in Ch Three, Subsection 3.1.1 (The Call for New Mechanism to Deal with Investor-State Disputes).

[4] The ideas embodied in the Resolution suggested that defining the standards of admission and treatment of foreign investors as well as the amount of compensation in case of nationalization of property was a matter within domestic law and jurisdiction. See further discussions on this Resolution in Ch Six, Subsection 6.1.2 (Doctrine of Permanent Sovereignty over Natural Resources).

ad hoc international investment tribunals during the mid 1950s and earlier 1980s.[5] The awards addressing the illegality of oil nationalisations conducted in developing states of the Middle East put forward ideas which were served as the basis for the internationalisation theory. The ideas were heavily biased in side of foreign investors. [6]

The establishment of ICSID arbitration as a permanent neutral forum under the 1965 World Bank Convention[7] has advanced the investor/states dispute resolution system.[8] Allowing direct claims by foreign investors, the ICSID mechanism replaced other forms of dispute settlement such as the use of local courts of the host state and diplomatic protection.[9] Since the mid 1980s, the ICSID arbitration has became the most popular method of investor/state dispute settlement, when BITs began widely to accept providing for direct claims by investors.[10] Thus, unlike previous *ad hoc* arbitral tribunals, ISCID is an investment treaty arbitration enforcing obligations of BITs.

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[5] See discussions in Ch Three, Subsections 3.1.2 (The Development of the Theory of Internationalisation) and 4.2.2 (Changing the Tradition of the Party Autonomy Principle).

[6] It is not contested that the earlier system of international investment arbitration served the interests of the Western states. See Jan Paulsson, 'Third World Participation in International Investment Arbitration' (1987) 2 ICSID Review- *Foreign Investment Law Journal* 19, 21. Also see Muthucumaraswamy Sornarajah, *International Commercial Arbitration: the Problem of State Contracts* (1990) 6-11.

[7] *Convention on the Settlement of Investment Disputes between States and Nationals of Other States,* opened for signature 18 March 1965, 575 UNTS 159 (entered into force 14 October 1966) [hereinafter *ICSID Convention*].

[8] It is the first specialised dispute settlement mechanism which operates permanently and only deals with disputes "arising directly out of an investment between a Contracting State and a national of another Contracting State" (Art 25 of the *ICSID Convention*) and disputes "where only one of the parties was connected to a Contracting State and to matters which do not arise directly out of an investment" (the 1979 Additional Facility Rules).

[9] Under the *ICSID Convention*, once an investor has made a direct claim against the host state, both parties are precluded pursuing other remedies (Art 26), and the national state of the investor is also forbidden from exercising diplomatic protection with respect to disputes submitted to ICSID (Art 27 (1)).

[10] Between 1987 and 2007 the total cumulative number of known treaty-based cases reached 290. These disputes were filed with ICSID (or the ICSID Additional Facility) (182), under the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL) (80), the Stockholm Chamber of Commerce (14), the International Chamber of Commerce (5), and ad- hoc arbitration (5). One further case was filed with the Cairo Regional Centre for International Commercial Arbitration, one was administered by the Permanent Court of Arbitration and for two cases the exact venue was unknown at the time of writing. The overwhelming majority of these cases were initiated on grounds of violating a bilateral investment treaty (BIT) provision (78 per cent), followed by the *North American Free Trade Agreement (NAFTA)* (13 per cent) and the *Energy Charter Treaty* (6 per cent). See UNCTAD, *Latest Developments in Investor-State Dispute Settlement* (2008) 1-2.

Despite various efforts made by developed states to establish a global regime for international investment, no multilateral arrangements have ever been achieved.[11] However, numerous bilateral, and to a lesser extent, multilateral agreements have emerged which confirm and extend notions that favored movement of foreign investment and their treatment in accordance with external standards.[12] The provisions of these agreements mainly prohibit host countries from taking regulatory measures and restrictions on the entry and operations of foreign firms[13] and require host countries to apply higher standards of treatment than that is provided under customary international law[14] and to eliminate any discrimination against foreign enterprises. In order words, these international investment treaties whether bilateral or regional, have created a positive legal environment for foreign investors and their investments, thereby encouraging investors to invest more.

In addition to this, from the end of World War II, developed states have pursued liberalisation and free market ideals through the world's leading economic organisations such as International Monetary Fund (IMF), the World Bank and the World Trade Organisation (WTO). These liberalisation policies allow foreign-investor companies to undertake bigger commercial activities beyond their own countries' borders while requiring states to open up their markets. Such policies have been much more beneficial to developed states which enjoy a competitive "wealth" advantage than to developing states which usually lack the economic structure to

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[11] International Trade Organisation (ITO) of *Havana Charter* which contained a comprehensive set of investment rules failed to come into being in 1950. Also the 1944 Bretton Woods order attempted to regulate issues of international investment. OECD's *Draft Multilateral Agreement on Investment* (MAI) failed mainly because of its provisions biased in favour of foreign investors.

[12] For more detail on these treaties see Ch Five, Subsection 5.2.1 (International Investment Treaties).

[13] See, eg, *North American Free Trade Agreement between the Government of Canada, the Government of the United Mexican States and the Government of the United States of America*, opened for signature 17 December 1992, 32 ILM 296 (1993) (entered into force 1 January 1994) [hereinafter *NAFTA*]. Art 1106 prohibits, on the part of States parties to the agreement, the imposition or enforcement of a number of performance requirements "in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non- Party ..."

[14] The Hull Doctrine, which required compensation for foreign investors that was "prompt, effective and adequate", contradicted the minimum standard treatment of customary international law.

compete with Western big corporations.[15] Also, these economic liberalisation policies have placed constraints on states' ability to direct economic development and fashion social and economic policy.[16]

It is evident therefore, that the rules and policies advanced by industrialised states are designed to benefit the interests of large transnational corporations (TNCs). By the early 1990s, ninety percent of world's largest 37,000 TNCs had their headquarters in developed states.[17] As a result, the great bulk of their sales and assets were concentrated in parent companies or home states.[18] Since trade and capital primarily rest in the hands of developed states, a free trade agenda works for them, but not for developing states.[19]

5.1.2. PERSPECTIVES OF DEVELOPING STATES

From the very beginning of the decolonization of the early 1960s, the South or the Third World states have been concerned with the legitimacy of international rules built up on western notions.[20] With the active support of the Soviet Union that had emerged as one of the great political powers after its victory over fascism, developing states struggled to restructure the

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[15] See generally Kyle Bagwell and Robert Staiger, 'Multilateral Trade Negotiations, Bilateral Opportunism and the Rules of GATT/WTO' (2004) 63 (1) *Journal of International Economic Law* 1-29.

[16] For example, Christopher McCrudden observed that domestic human rights purposes such as tackling long-term unemployment, promoting fair labour conditions, promoting the use of local labour in economically deprived areas may be invalid under international trade law disciplines. See Christopher McCrudden, 'International Economic Law and the Pursuit of Human Rights: A Framework for Discussion of the Legality of 'Selective Purchasing' Laws under the WTO Government Procurement Agreement' (1999) 2 (1) *Journal of International Economic Law* 3-48.

[17] UNCTAD, *World Investment Report* (2005) 13.

[18] Paul Hirst and Graham Thompson, *Globalization in Question* (2nd ed, 1999) 82.

[19] Critics of foreign direct investment in developing countries argue that trade and investment liberalisation policies cause disastrous effect on developing states. For example, Morris argues that the benefits to which developed countries have become accustomed now threaten developing economies as wage rises, environmental protection, and insurance and employer liability lift costs of production and reduce international competitiveness. David Morris, 'Free Trade: The Great Destroyer' in Jerry Mander and Edward Goldsmith (eds), *The Case Against the Global Economy* (1996) 223.

[20] In the post-decolonization era, international law was perceived by anti-colonial legal scholarship as "Eurocentric" meaning that international law is founded by European 'civilized" states to benefit them. See Mohammed Bedjaoui, 'General Introduction' in Mohammed Bedjaoui (ed), *International Law: Achievements and Prospects* (1991) 5.

international legal and economic order in accordance with their own interests and needs. In this regard, the UN General Assembly (GA) was extremely active in promoting changes to existing law and introducing new concepts that reflect aspirations of developing states.

The Third World states aimed at first, at preserving national sovereignty and maintaining control over all aspects of their political and economic life. For their achievement of economic independence, these countries used nationalisation as a means of freeing the national economy from foreign control and creating state ownership.[21] As a result of the nationalisation, the key sectors of the economy such as land, natural resources and other wealth previously owned by nationals of the former colonial states were transferred to newly-sovereign governments of the Third World states.

The second step towards the new international legal system was the adoption of a number of principles that give nations or peoples of the newly independent states a chance to control their economies. Among the new norms promoted by the GA, the doctrine of permanent sovereignty over natural resources has greater legal status in international law.[22] The significance of the principle is that it ensured that total control over foreign investment activities in the area of natural resources belongs to the host state. Therefore, it has shaken the whole content and nature of the theory of internationalisation that aimed to withdraw the host state's control.

Throughout the 1970s and 1980s, developing states not just continuously affirmed the principles of economic independence, but also, together with former socialist states, had demanded to participate more effectively in decision making on international economic matters and proposed changes to the old economic system. In this regard, a program for a *New*

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[21] M M Boguslavskii, *Private International Law: The Soviet Approach* (1988) 123.

[22] Some writers argue that the doctrine constitutes a principle of *jus cogens* of international law. See, eg, Ian Brownlie, 'Legal Status of Natural Resources in International Law' (1979) 162 *Hague Recueil* 245, 271.

International Economic Order (NIEO)[23] was the most remarkable initiative. The idea of the NIEO had, in fact three general connotations; first, there is something wrong with the existing system of international economic relations, which needs to be corrected by a change in the system, second, that the wrong originated from the past and present policies of Western countries, which for their guilt should accept the obligations of the NIEO, and third, that the change in the system requires a massive shift of political power from the major countries to the United States.[24]

In spreading the NIEO ideology, the role of the United Nations, especially the United Nations Conference on Trade and Development (UNCTAD), was central. UNCTAD advanced a global reform strategy with three main prongs. The first was commodity price stabilization, the second was a scheme of preferential tariffs for Third World exports in First World markets, and the third was an expansion and acceleration of foreign assistance.[25]

The next effort of developing states in the evolution of new international economic regime was the elaboration of values and moral standards concerning developmental needs of nation states. These values and principles are now considered to be the subject matter of an emerging branch of public international law which recognizes people's right to develop.[26] The significant point of the evolution of the new law is the assertion that foreign investment activities must meet the host states' developmental prerogatives.[27]

Apart from developing states, environmentalists and human rights activities have been protesting against the unfair nature of international law in the field of foreign investment since the 1970s. One of the important steps made by human rights advocates through NGOs has been

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[23] *Declaration on the Establishment of a New International Economic Order*, GA Res 3201 (S-VI), UN GAOR, 6th secc, 2229th plen mtg, UN Doc A/Res/3201 (S-VI) (1974).

[24] Harry Jonhson, *The New International Economic Order, Selected Papers No 49* (1976) 1.

[25] Bernard Nossiter, *The Global Struggle for More* (1987) 45.

[26] It has been commonly accepted now as a new branch. See Oscar Schachter, 'The Evolving International Law of Development' (1976) 15 *Columbia Journal of Transnational Law* 1; Francis Snyder and Peter Slinn (eds), *International Law of Development: Comparative Perspectives* (1987).

[27] See Ch 6, Subsection 6.2.2 (Move to Economic Development Approach).

the promotion of an idea of the accountability of transnational corporations to ensure the observance of human rights by them. The NGOs have called on all actors of the international market place, particularly national governments, transnational corporations as well as international economic organisations such as the IMF, World Bank and WTO to ensure the compliance of corporate practices with international human rights standards.[28]

The development of a code of conduct for multinationals on the global level, that took more than 20 years' negotiating process, has been finalized as the UN Sub-Commission for the Promotion and Protection of Human Rights adopted *Norms on the Responsibilities of Transnational Corporations*.[29] Though the norms are non-binding, it will provide a definite new international standard or global guideline for behaviour of multinationals.[30] Most importantly, they have introduced human rights concerns to the normative content of international law on foreign investment.

As a result of the struggles of the two groups, developing states and the international human rights community, the nature of international law on foreign investment has undergone a great deal of change over the last two decades. The early law of the post-colonialism period concentrated on the single objective of the protection of foreign investors has sifted to new competing objectives of protecting human rights and environment. The next section examines

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[28] The idea for regulating behaviour of multinationals was broached by both governmental bodies and non-governmental organizations in the earlier seventies but the current revival of interest in "codes of conduct" for businesses has largely been led by non-governmental organisations (NGOs), including development organisations, trade unions and environmental groups. See *Codes of Conduct for Transnational Corporations: An overview* (1998) Cleanclothes org <http://www.cleanclothes.org/codes/overvieuw.htm> at 4 December 2005.

[29] *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights (the Norms)* UN Doc E/CN.4/Sub.2/2003/12/Rev.2 (2003).

[30] Under the *Norms*, the most remarkable responsibilities of transnational corporations and other business enterprises are respect for applicable norms of international law, national laws and regulations, as well as administrative practices, respect for the rule of law and the public interest, respect for development objectives, social, economic and cultural policies including transparency, accountability and prohibition of corruption, and authority of the countries in which the enterprises operate. Ibid, para 10.

rules of international law evolved through the theory of internationalisation of investment contracts.

5.2. Sources of International Law on Foreign Investment

It can be said that the ICSID Convention took a very vague view of international law. It does not give any definition what it meant by the expression "such rules of international law".[31] Suggestions to clarify the contents of "rules of international law" were made by reference to the established sources of international law which are stated in Article 38 (1) of the Statute of the International Court of Justice. In the Report of the Executive Directors, it was stated that

> "The term 'international law' as used in this context should be understood in the sense given to it by Article 38 (1) of the Statute of the International Court of Justice, allowance being made for the fact that the Article 38 was designed to apply to inter-State disputes".[32]

Therefore, sources of international law applicable to investment contracts should be looked at in a similar way as in the International Court of Justice.

5.2.1. INTERNATIONAL INVESTMENT TREATIES

As the Report of the Executive Directors directs, ICSID tribunals first look at treaties. It has been considered that negotiation and agreement on uniform substantive rules by governments through the treaty making process is the best solution to conflict of laws

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[31] Kahn, above n 2, 28.

[32] *Report of the World Bank Executive Directors on the Convention on the Settlement of Investment Disputes between States and Nationals of Other States,* adopted 10 September 1964, 4 ILM 524, para 40 (1965) [hereinafter *Executive Directors' Report*]. The following footnote was attached: Article 38 (1) of the Statute of the International Court of Justice reads as follows:

1. The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply:

a. international conventions, whether general or particular, establishing rules expressly recognised by the contesting states;
b. international custom, as evidence of a general practice accepted as law;
c. the general principles of law recognised by civilised nations;
d. subject to Article 59, judicial decisions and the teaching of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules law.

problems.[33] Since the late 19th century, public international law increasingly started to evolve in the context of private international law providing a framework for treaties for recognition and enforcement of civil judgments, codifying rules for choice of law, and defining other private law matters. In other words, public international law and private international law that once were independent branches of law with clear-cut principles and rules started to merge rules.[34]

However, it should be noted that international negotiations often fail unless they achieve agreement among widely diverse states with language and cultural differences, civil and common law traditions, capitalist and socialist political philosophies, and developed and developing economies.[35] One of the fields of transnational activity where multilateral treaty negotiation has not reached an agreement is foreign investment. During the last half century there have been many efforts at contributing to a global, codified international investment law through binding and non-binding international agreements.[36]

The most recent attempt by the Organisation for Economic Cooperation and Development (OECD) to create a truly global investment code, the *Multilateral Agreement on Investment* (MAI), was unsuccessful mainly because of its provisions for excessive liberalisation of international investment, and its unbalanced regime for the protection of interests of foreign private parties against the host states of such investment.[37]At present, the attempts to negotiate a

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[33] Alina Kaczorowska, *International Trade Conventions and Their Effectiveness: Present and Future* (1995) 26.

[34] Some writers argue that the traditional gap between international law and private international law has narrowed. See Mark Janis, 'Should We Continue to Distinguish Between Public and Private International Law?' (1985) 79 *American Society of International Law Proceedings* 352.

[35] Trachtman acknowledges that treaty negotiation often is impracticable because of levels of controversy. Joel Trachtman, 'Conflict of Laws and Accuracy in the Allocation of Government Responsibility' (1994) 26 (5) *Vanderbilt Journal of Transnational Law* 975, 990-91.

[36] The *OECD Codes* (1976) created by developed countries, the *UN Code on Transnational Corporations* (1976-1992), the *World Bank Foreign Investment Guidelines* (1992) have non-binding character, while three other treaties: The *1992 North-American Free Trade Agreement*, the *1994 Mercosur Agreements with its Colonia Protocol* dealing with investment, and the *1994 Energy Charter Treaty* are binding agreements.

[37] See Sol Piccioto, 'A Critical Assessment of the MAI' in Sol Piccioto and Ruth Mayne (eds), *Regulating International Business: Beyond Liberalization* (1999) 82.

multilateral treaty on investment regulation have reached an agreement in only two fields particularly procedures for international settlement of investment disputes (ICSID) and multilateral investment guarantee (MIGA) facilities.

Basic Similarities of International Investment Treaties (IITs)

Since attempts to negotiate a multilateral agreement on investment at the WTO or the OECD have failed to come up with a binding agreement, regional and bilateral treaties are the main sources in this field. Though each treaty has its own structure, scope and objectives, they share some basic features. Therefore, before discussing them separately, a general indication of most commonly shared features of the existing IITs should be provided.

First, structurally, modern investment treaties have retained broad uniformity in their provisions. They begin with determining the scope of application of the treaty providing the definition of foreign investment. In most cases the definition is so broad covering tangible and intangible assets, direct as well as portfolio investments. Basically all investment treaties cover four substantive areas:

- admission of investments; (definition of investment,[38] right of entry and performance requirements[39])
- treatment of investment; (national and most-favoured-nation treatment, fair and equitable treatment, non-discrimination and free transfer of funds)[40]
- expropriation; (prohibition of expropriation and prompt, adequate and effective compensation in the case of expropriation)[41]
- the settlement of disputes; (either State-to-State or investor-to-State)[42]

[38] See Appendix I, *Mongolia – US Bilateral Investment Treaty,* Art I.

[39] See Appendix I, *Mongolia – US Bilateral Investment Treaty,* Art II (1) and (5).

[40] See Appendix I, *Mongolia – US Bilateral Investment Treaty,* Art II (2) and (8).

[41] See Appendix I, *Mongolia – US Bilateral Investment Treaty,* Art III (1), (2), and (3).

[42] See Appendix I, *Mongolia – US Bilateral Investment Treaty,* Art V and VI.

Second, they provide similar standards of treatment of foreign investment or foreign investors. IITs rely on a combination of standards, "national treatment", "fair and equitable treatment", "full protection and security" and the "treatment in accordance with international law". Most of them guarantee "fair and equitable treatment" which means a state must treat the foreign investor in accordance with certain basic standards no matter how it treats its own nationals.[43] Along with this, they also require that "full protection and security" be accorded in respect to the investor's rights regarding ownership, control and benefits over his property including intellectual property.[44]

The next feature of IITs is that they provide protection against expropriation. Most IITs prohibit nationalisation or expropriation and measures tantamount to expropriation by a host state. Expropriation is allowed only when all basic criteria are met: which are that it was for a public purpose, done on a non-discriminatory basis and accompanied by compensation equal to the market value of the investment.[45] In addition, many IITs often impose certain duties on the host state such as to stabilise the national legal regime, to negotiate in good faith and to obey contractual obligations.[46]

The last significant feature of IITs is that a reference to social, developmental and environmental concerns of host states is missing from the contents of IITs whether regional or bilateral. They are usually silent as to the need for government intervention or regulation to

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[43] Daniel Price, *Foreign Investment Protection under International Treaties* (2006) Research Institute of Economy, Trade and Industry < http://www.rieti.go.jp/en/events/bbl/06070601.html> at 23 November 2007.

[44] Sacerdoti, Giorgio, 'The Source and Evolution of International Legal Protection for Infrastructure Investments confronting Political and Regulatory Risks' (2000) 5 *The Centre for Energy, Petroleum and Mineral Law and Policy (CEPMLP) Internet Journal* <http://www.dundee.ac.uk/cepmlp/journal/html/vol5/article5-7a.html> at 18 March 2006.

[45] See Appendix I, *Mongolia – US Bilateral Investment Treaty,* Art III (1).

[46] See, eg, *ASEAN Investment Agreement* , signed 15 December 1987 by the Governments of Brunei Darussalam, the Republic of Indonesia, Malaysia, the Republic of the Philippines, the Republic of Singapore and the Kingdom of Thailand < http://www.aseansec.org/6464.htm> at 3 February 2007. Art 3 (3) states:

"Each Contracting Party shall observe any obligation arising from a particular commitment it may have entered into Title with regard to a specific investment of nationals or companies of the other Contracting Parties."

further its environmental, developmental, health and human rights goals.[47] As a result, there is a danger that any attempt by a host government to take a measure for public policy reasons could be interpreted as expropriation or discrimination. The government faced with this issue has to choose either not to take such public policy action or to pay millions of dollars for compensation. More specifically, the Mexican government was forced to pay a US company US$16 million based on the refusal to allow Metalclad to operate a hazardous waste facility.[48] Similarly, in the mid-1990s US tobacco companies threatened Canada with an investment treaty suit alleging expropriation of trademarks if Canada would move forward with a public health-inspired proposal for plain packaging of cigarettes and tobacco products.[49]

Regional Investment Treaties

At a regional level, two treaties that impose obligations on governments to protect foreign investments and accord them more favourable treatment were adopted in the early 1990s. The first one is the *North American Free Trade Agreement (NAFTA)* which was signed in 1992 by Mexico, Canada and the US. Most provisions of the treaty were built on the 1988 Canada-United States Free Trade Agreement (CUSFTA) thus it is often referred as CUSFTA's successor.

NAFTA is generally regarded as an important codification of disciplines and procedures concerning international investment. It provides higher level standards of protection and liberalisation than those found in other investment agreements and customary international law and offers a dispute settlement mechanism for both state-to-state and investor-to-state disputes. More specifically, both investors and their investments are entitled to the better of national

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[47] UNDP, *Investment Provisions in Free Trade Agreements and Investment Treaties* (2005) INDI Regional centre in Columbia <http://www.undprcc.lk/Publications/Publications/BIT-completed.pdf > at 24 February 2008.

[48] See *Metalclad Co v United Mexican States* (Award on Merits) (30 August 2000), 40 ILM 36 (2001).

[49] See Affadavit of David Schneiderman, in Council of Canadians, CUPW, et.al. v Attorney General of Canada, Ontario Superior Court of Justice, Court File No 01-CV-208141, at 4-5.

treatment and MFN treatment and investments are entitled to "treatment in accordance with international law, including fair and equitable treatment and full protection and security"[50] freedom of transfers,[51] and protection against expropriation without compensation.[52] However, *NAFTA* differs from other trade arrangements in its attention to environmental issues and in the degree to which it places environmental concerns before commercial considerations.[53]

The second treaty is the *Energy Charter Treaty (ECT)* which was signed in December 1994 and which entered into legal force in April 1998. Its scope is limited to the energy sector establishing legal rights and obligations with respect to a broad range of investment, trade and other subjects such as the transit of energy goods, competition, the environment, access to capital markets and transfer of technology. The treaty, which initially was designed to be a European Energy Charter creating a privileged relationship between West and East of Europe in the energy sector, has became a multilateral treaty as the US, Canada, Australia and Japan joined in.[54]

One of the important features of the *ECT* is that it does not only provide a variety of protections to foreign energy investors but also tried to set up some sort of balance between the rights of investors and the rights of the host state. In particular, the *Charter* recognises the exercise of certain discretionary powers by a host country under the applicable national legal order pertaining to foreign investment such as controls over illicit payments and the extension of competition laws to their activities, and preserves discretion to take measures for national

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[50] *NAFTA,* Art. 1105 (1).

[51] *NAFTA,* Art. 1109.

[52] *NAFTA,* Art. 1110.

[53] See Ch Six, Section 6.2.2 (Move to Economic Development Approach).

[54] Greg Bamberg, Jan Linehan and Thomas Waelde, 'The Energy Charter Treaty in 2000: In the New Phase' in Martha Roggencamp (ed), *Energy Law in Europe* (2000).

security or other vital public policy reasons.[55] The *ECT* also allows member states to take precautionary measures to prevent or minimise environmental degradation," and to "take account of environmental considerations throughout the formulation and implementation of their energy policies".[56]

At the multilateral level, agreements negotiated at the WTO also can impact on the domestic regulations of a host country that apply to foreign investors. *An Agreement on Trade-Related Investment Measures (TRIMs)*[57] which was concluded as part of the Uruguay Round of negotiations and entered into force on 1 of January 1995 regulates various trade-related investment measures. The purpose of the agreement is to restrict preference of domestic firms and thereby enabling international firms to operate more easily within foreign markets.

It requires member states to notify investment measures that restrict and distort trade and eliminate them within a limited period of time.[58] It provides that no contracting party shall apply any TRIM inconsistent with Articles III (national treatment) and XI (prohibition of quantitative restrictions) of the *GATT*.[59] The *TRIMS Agreement* does not explicitly define what a trade related investment measure, but provides an illustrative list that explicitly prohibits local content requirements, trade balancing requirements, foreign exchange restrictions and export restrictions (domestic sales requirements) that would violate Article III (4) or XI (1) of *GATT 1994*.[60]

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[55] *ECT,* Art 18

[56] *ECT,* Art 19.

[57] *Trade Related Investment Measures (TRIMs),* 15 April 1994, Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Legal Instruments-Results of the Uruguay Round, Annex 1A.

[58] Developed, developing and least-developed countries were given, respectively, two, five and seven years from the date of entry into force of the WTO agreement to eliminate notified TRIMs. See *TRIMs,* Art 5 (2).

[59] *TRIMs,* Art 1.

[60] See *TRIMs,* Annex.

As any other WTO regulations, the *TRIMS Agreement* is designed to eliminate barriers to trade and investment flows. Since the late 1980s, developing countries receiving foreign investment have imposed numerous restrictions to protect and foster domestic industries and to capture more benefits from FDI.[61] The most undesirable effect of the *TRIMS Agreement* is that it will seriously hinder the efforts of developing countries to promote local industries. Liberalisation between two unequal partners such as TNCs and local enterprises is as a likely result to throw local medium and small companies out of business.[62]

Bilateral Investment Treaties

According to a list of treaties published by ICSID, the first modern bilateral investment treaty was concluded between Germany and Pakistan in 1959. Since then an increasing number of European countries concluded similar treaties with developing states. However, only since the end of the 1980s, the bilateral investment treaties have become universally accepted as instruments for the promotion and legal protection of foreign investment.[63]

The number of investment treaties increased rapidly over the past 20 years and the rapid proliferation of these treaties witnessed to date appears to continue. By the end of 2006, more than 2,500 bilateral investment treaties (BITs), 2,600 double taxation treaties and 240 other agreements with investment provisions such as free trade agreements have been concluded across the globe.[64] It also shows that these treaties are no longer concluded exclusively between

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[61] Chaipa Tekere, *Impact of the WTO TRIMS Agreement on the Marginalized in Developing Countries* (2007) Trade and Investment Study Centre <http://www.tradescentre.org.zw/publications/index.html> at 23 January 2008.

[62] Ibid.

[63] For a list of bilateral investment treaties and related information, see the World Bank's website at http://www.worldbank.org/icisid/treaties/intro.htm.> at 27 February 2008.

[64] UNCTAD, *Developmental Implications of International Investment Agreements* (2007) 2.

capital-exporting and capital-importing countries but that an increasing number of the treaties are concluded between developing countries themselves.[65]

However, it is doubtful whether the increasing treaty development in the field of foreign investment witnesses the success of the development. Actually, these treaties are meant to ensure mutual promotion and protection of foreign investment. But in reality, the investment is a one-way flow because investment usually comes from developed states to developing states, not from developing states to developed states.[66] In particular, a recent OECD report shows that in 2006 direct investment outflow of Turkey was only 0, 9 billion, whereas that of the USA in the same year was 248, 9 billion.[67]

In these asymmetrical relationships, developed states are the party whose large stake of investment is protected, and thus benefit from the provisions of BITs, while developing states are other party whose government is restrained from taking certain actions and sued by foreign individuals before an external mechanism. Even rule-makers do not deny that BITs were historically intended only for developing countries.[68] For their part, developing states have accepted such investment treaties as a way to promote foreign investment in their territories and have thus willingly negotiated them. In the hope that these treaty provisions will attract

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[65] At the end of 2006, the total number of South–South agreements reached 680. See UNCTAD, *Recent Developments in International Investment Agreements:* 2006- June 2007 (2007) 3. <http://www.unctad.org/en/docs/webiteiia20076_en.pdf. > at 23 December 2007.

[66] Salacuse commented "A BIT purports to create a symmetrical legal relationship between the two states, for it provides that either party may invest under the same conditions in the territory of the other. In reality, an asymmetry exists between the parties to the BITs since one state will be the source and the other the recipient of any investment flows between the two countries. Jeswald Salacuse, 'BIT by BIT: The Growth of Bilateral Investment Treaties and their Impact on Foreign Investment in Developing Countries' (1990) 24 *International Lawyer* 662.

[67] OECD, *International Investment Perspective in a Changing World* (2007) 17, Table 2.1. <http//www.oecd.org/dataoecd/62/43/38818788.pdf> at 17 March 2008.

[68] Daniel Price, one of the American negotiators of NAFTA Ch 11, admitted that these types of provisions were historically intended for developing countries such as Mexico. See Daniel Price, 'An Overview of the NAFTA Investment Ch: Substantive Rules and Investor-State Dispute Settlement' (1993) 27 *International Lawyer* 727, 736.

more foreign capital and the capital would benefit its economy, poorer governments agree to be bound by the unfavourable provisions.[69]

Chapter 11 of *NAFTA* was the first occasion when two developed OECD countries [the US and Canada] have made the same commitments to each other that they have demanded of developing countries.[70] The investment protection accorded under the *NAFTA* has resulted in excessive claims launched against all three NAFTA governments.[71] For Mexico, as a developing state being brought before an international tribunal by foreign individuals is not a surprise, but for the US and Canada, this has been an inconvenient experience.[72] Learning from the NAFTA experiences, developed states now are seeking a mechanism to reduce their risks of being sued.[73] Such an attempt was made in the *Australia-United States FTA (AUSFTA)* which was signed on 18 May 2004.

Both the US and Australia are parties to *ICSID Convention*, but they did not give investors the right to pursue direct claims with governments. Under Article 11.16, parties should consider through consultations whether to allow investor-state dispute settlement if "there has been a change in circumstances affecting the settlement of disputes on matters

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[69] Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (2nd ed, 2004) 207.

[70] Price, above n 68.

[71] As of March 2008, 13 cases have been filed against the USA, 4 against Canada, and 12 against Mexico. See US Department of State, *The NAFTA Investor-State Arbitrations* <http://www.state.gov/s/l/c3439.htm > at 27 March 2008.

[72] Under *NAFTA* corporations are encouraged to attack government regulations to improve the food security, public health, and safety of its citizens. As a result, in the most cases filed under *NAFTA*, all three governments have been sued for providing public service and regulating economic activities. Eg, in *Ethyl Corporation Case,* a US company claimed that a Canadian ban on the gasoline additive MMT breached *NAFTA* Ch 11. After the preliminary tribunal judgments against Canada, Canadian government annulled the statute, issued an apology to the company and paid US $13 million in compensation. *Ethyl Corporation v Government of Canada* (Jurisdiction) (24 June 1998), 38 ILM 708 (1999).

[73] Dodge considers that the reason for the absence of investor-state dispute settlement provisions in *AUSFTA* is a desire to avoid the experiences of the United States and Canada under *NAFTA* Ch 11." See William Dodge, 'Investor-State Dispute Settlement between developed Countries: Reflections on the Australia- United States Free Trade Agreement' (2006) 39 (1) *Vanderbilt Journal of Transnational Law* 1.

within the scope of this Chapter."[74] Then, *AUSFTA* Chapter 11 is only enforced through the state-to-state dispute settlement procedures set forth in Chapter 21.[75]

The removal of investor-state provisions from *AUSFTA* will have both negative and positive implications for international investment law which is still developing. The drafters of AUSFTA moved backwards undermining the most significant accomplishment of foreign investors which is a right to pursue a host state before an international arbitral tribunal.[76] The whole idea of developing international investment arbitration mechanism was to grant to individuals the capacity to protect themselves on the international plane without the intermediary of their states. The approach taken in the *AUSFTA*, therefore may damage this positive development of international law.[77]

On the other hand, the *AUSFTA* experience illustrates a need for the reconstruction of multilateral or bilateral investment treaties to respect the environment and recognise regulatory measures by a host state addressing important environmental and social issues and concerns of foreign investment. Developed states now fear powers given to corporations by investment treaties. Thus, they are unlikely to grant foreign investors from other developed states the NAFTA-standard-mechanism of protection in future FTAs.[78] Even though the current practice

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[74] *Australia-US FTA*, signed 18 May 2004, Art 11.16 available at <http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Australia_FTA/Final_Text/asset_upload_file819_5164.pdf> at 13 December 2008.

[75] Chapter 21 provides in the first instance for consultations between the state parties (Art 21.5) and referral to the standing Joint Committee established by the agreement (Art 21.6). If these fail to resolve the dispute, it may be taken to a dispute settlement panel of three (Art 21.7). The panel may determine if the measure at issue is a breach of the agreement but does not award damages (Art 21.9).

[76] Dodge wrote:

> "What Australia and the United States have created, then, is a system for protecting foreign investors that depends entirely on diplomatic protection and resembles those in operation before the advent of ICSID and the BITs. Indeed, in one respect, the agreement is even more restrictive than earlier treaties, for breaches of AUSFTA may not be raised in domestic courts, whereas the provisions of earlier treaties could in at least some instances." See Dodge, above 73, 25.

[77] For the benefits of investor-state arbitration compared to state-to-state method, see Rafael Pacquing, *Investor-State Arbitration: Canada's Experience in NAFTA and the Case for its Inclusion in the Australia-US FTA* (2003) APEC Study Centre <http://www.apec.info/asia/AUAPEC/pacquing2003.pdf > at 23 March 2008.

[78] Dodge, above n 73, 35.

of BITs treats unequally developed and developing states, the *AUSFTA* approach will have a profound impact on the negotiation process of future BITs.

It also should be noted that the new rules and standards evolved by the international law on economic development in the last three decades have been reflected in numerous bilateral investment treaties. As a result, the normative content and scope of BITs are gradually changing. In particular, a recent UNCTAD research report identified several important features introduced by new and newly re-negotiated BITs.[79] First, the new generation of treaties clarifies the meaning of minimum standard of treatment and the concept of indirect expropriation in line with a traditional interpretation given by arbitral tribunals. For instance, in the new Canada and United States model BITs it is accepted that an adverse effect on the economic value of an investment alone, does not establish that an indirect expropriation has occurred.[80] In addition, both BIT models state that, except in rare circumstances, non-discriminatory regulatory actions by a Party aimed at protecting legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.[81]

Another significant feature is that the new generation BITs address not only specific economic aspects, but also other issues affecting the protection of health, safety, the environment, and the promotion of internationally-recognised labour rights.[82] Lastly, new generation BITs make significant innovations to investor-State dispute settlement procedures such as greater and substantial transparency in arbitral proceedings, including open hearings,

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[79] UNCTAD, *Recent Developments in International Investment Agreements* (2005). <http://www.unctad.org/sections/dite_dir/docs/webiteiit20051_en.pdf> at 30 August 2007.

[80] See *2004 US Model BIT,* Annex B (a) (ii) <http://www.state.gov/documents/organization/38710.pdf > at 23 January 2008; *2004 Canadian Model BIT,* Annex B.13 (1) (b) (i) <http://ita.law.uvic.ca/documents/Canadian2004-FIPA-model-en.pdf > at 23 January 2008.

[81] See *2004 US Model BIT,* Annex B (b) <http://www.state.gov/documents/organization/38710.pdf > at 23 January 2008; *2004 Canadian Model BIT,* Annex B.13 (1) (c) <http://ita.law.uvic.ca/documents/Canadian2004-FIPA-model-en.pdf > at 23 January 2008.

[82] See *2003 Korea-Chile FTA*, the Preamble <http://www.sice.oas.org/Trade/Chi-SKorea_e/ChiKoreaind_e.asp > at 23 January 2008.

publication of related legal documents, and the possibility for representatives of civil society to submit "*amicus curiae*" briefs to arbitral tribunals.[83]

Along with the new developments in investment treaties, arbitral tribunals' attitude towards treaty law also has changed. It has been acknowledged in recent arbitral awards that treaty provisions should not limit and restrain the host state's legitimate rights to regulate an investment in accordance with its national policy goals. Particularly, in the *CMS Gas Transmission Company* case the tribunal emphasised:

> "… these treaties [BIT] cannot entirely isolate foreign investments from the general economic situation of a country. They do provide for standards of fair and equitable treatment, non-discrimination, guarantees in respect of expropriation and other matters, but they cannot prevent a country from pursuing its own economic choices."[84]

In light of these considerations, some departure from the investment-protection-based-structure of international investment treaties ought to be acknowledged. Investment protection is no longer the exclusive aim of international investment treaties. Some public policy measures of a host government, especially regarding the environment are also likely to be included in investment treaties.

5.2.2. CUSTOMARY INTERNATIONAL LAW

The next important source of international law is customary rules or state practice. However, unlike treaty rules, customary rules may be difficult to establish due to their unwritten nature. In principle, international customs are a general and consistent practice of

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[83] See *2004 US Model BIT,* Art 28 <http://www.state.gov/documents/organization/38710.pdf > at 23 January 2008; *2004 Canadian Model BIT,* Art 19 < http://ita.law.uvic.ca/documents/Canadian2004-FIPA-model-en.pdf > at 23 January 2008.

[84] *CMS Gas Transmission Company v The Argentine Republic* (Decision on Objections to Jurisdiction) (17 July 2003), 42 ILM 788 (2003), para 29.

states followed by them from a sense of legal obligation. Another difficulty is that the evidence of state practice can be found in a wide variety of sources.[85]

In the field of foreign investment there are a few customary international rules whose existence is undisputed.[86] The issue of state responsibility for injuries suffered by aliens within its territory has historically led to the building up of norms and principles of international law on treatment of aliens by host states. Under the norms and principles of international law, a state whose subjects were injured by acts contrary to international law committed by another state was entitled to protect them.

The protection of individuals' rights in international scene was traditionally ensured by the method of diplomatic protection.[87] Because individuals were not in a position to defend their interests at international level, a State had to do this on their behalf. By virtue of the diplomatic protection, when a national of one state suffered an injury within another state's territory, only the state of which the individual is a national was entitled to demand reparations.

The customary international law of diplomatic protection was spelled out in a more comprehensive manner in practices of the PCIJ and the ICJ. In the *Mavrommatis Palestine Concessions* case, decided by the PCIJ in 1924 the Court held:

> "It is true that the dispute was at first between a private person and a state... The dispute then entered upon a new phase; it entered the domain of international law, and became a dispute between two states... It is an elementary principle of international

[85] In 1950, the International Law Commission listed the following sources as forms of evidence of customary international law: treaties, decisions of national and international courts, national legislation, opinions of national legal advisors, diplomatic correspondence, and practice of international organizations. See [1950] 2 *Year Book of the International Law Commission* 367, UN Doc A/CN.4/Ser.A/1950/Add.1 (1957).

[86] Sornarajah argued that if there was customary international law on investment protection, there would be no need to confirm so many times over what already existed by making bilateral investment treaties. Sornarajah, above n 69, 213.

[87] For literature on the law in the area of diplomatic protection, see Edvin Borchard, *The Diplomatic Protection of Citizens Abroad or the Law of International Claims* (1915); Frederick Dunn, *The Protection of Nationals: A Study in the Application of International Law* (1932).

> law that a state is entitled to protect its subjects, when injured by acts contrary to international law committed by another state, from whom they have been unable to obtain satisfaction through the ordinary channels…Once a state has taken up a case on behalf of one of its subjects before an international tribunal, in the eyes of the latter the state is sole claimant." [88]

However, a modern principle of protection of foreign investment rejects the use of diplomatic protection. This was a conclusion of the drafters of the Washington Convention that, in exchange for direct access to an international jurisdiction, investors should not be in a position to ask protection from their home States.[89]

The next significant rule of customary international law applicable to state/alien relationship is the incorporation theory that determines the connection between a certain legal person and a state.[90] The theory implies that a corporation is a national of a state where the foreign legal person is incorporated and physically exists. Shortly, the act of incorporation provides for a foreign company a 'licence" to carry out economic activity on a sovereign territory of the state.

In the sense of the incorporation theory, an incorporated company is a distinct legal person separate from its shareholders or individuals founded it. It has its own rights and obligations under national law of the state where it is incorporated. Therefore, the shareholders of that incorporated company are legally unable to bring disputes between the state and its incorporated company under international law, insulating the company from the legal system under which it was created and operated.

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[88] *Mavrommatis Palestine Concessions (Greece v UK)* [1924] PCIJ (ser A) No 2, at 11-12.

[89] See *Executive Directors' Report,* above n 32, para 33.

[90] Though there are also other techniques that determine the corporate nationality, the incorporation theory is the dominant one. It has been supported by various writers and has been accepted in arbitral awards, it also has been criticized by other scholars. See general discussion of these criteria in Ignaz Seidl-Hohenveldern, *Corporations In and Under International Law* (1987) Ch 10. Also see Roberto Bruno, *Access of Private Parties to International Dispute Settlement: A Comparative Analysis* (LLM Thesis, NYU School of Law 1997).

This rule was clearly affirmed by the ICJ in the *Barcelona Traction* case. The court here stressed that, for purposes of diplomatic protection, the nationality of a company should be established by reference to its place of incorporation and its principal seat of management, not by reference to the nationality of the controlling shareholders through a lifting of corporate veil.[91] In particular, the Court so held:

> "In allocating corporate entities to states for purposes of diplomatic protection, international law is based, but only to a limited extent, on an analogy with the rules governing the nationality of individuals. The traditional rule attributes the right of diplomatic protection of a corporate entity to the state under the laws of which it is incorporated and in whose territory it has its registered office. These two criteria have been confirmed by long practice and by numerous international instruments."[92]

As the incorporated company is unable to seek diplomatic protection or international protection against the country where it is incorporated, this custom would be inconsistent with the objective of the theory of internationalisation. However, in order to avoid the conflict and extend the scope of investment protection covering all foreign-controlled investments, the *ICSID Convention* made a modification to this rule. Under the *Convention*, national of another contracting state means any juridical person which had the nationality of a Contracting State other than the State party to the dispute and which because of foreign control, the parties have agreed should be treated as a national of another Contracting State for the purposes of this *Convention*.[93]

On the other hand, even if the company is unable to pursue a claim against the host state because of the incorporation theory, shareholders in that local company are free to pursue the claim in their own names. The ICJ in the *ELS*I case had recognised the direct protection of shareholders under bilateral treaties. In that case, rejecting the Italian argument based on the

[91] See *Barcelona Traction, Light and Power Co ltd (Belgium v Spain)* [1970] ICJ Rep 3.

[92] Ibid, 42.

[93] *ICSID Convention*, Art 25 (2) (b).

incorporation theory, the ICJ held that, in respect of acts committed against the corporation, the provisions of the Treaty dealing with foreign investment conferred rights on shareholders as well.[94] Thus, the Court had allowed the United States to protect American nationals who were shareholders in an Italian company.

However, one should note that in the context of investor-state arbitration, tribunals have taken inconsistent approaches to the issue of a corporate nationality and used to interpret established rules of international law to broaden the scope of investment protection. In earlier decisions, tribunals looked beyond the place of incorporation and accepted the 'control test' in determining the foreign investors' nationality.[95] In recent decisions of investment treaty arbitrations, tribunals have opted for the incorporation test instead of inquiring into the actual control and ownership of the firm. The mechanical application of the incorporation theory has resulted in a transformation of the object and purpose of the whole investor-state arbitration system. In the *Tokios Tokelës*,[96] Ukrainian nationals, who established an entity in the territory of Lithuania and re-invested in their home state, were regarded by the tribunal as "foreign investors", so they were allowed to pursue international arbitration against their own government.[97] Likewise, in the *Saluka,* nationals of third country (the UK) who have been

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[94] *Elettronica Sicula SpA (ELSI) (United States v. Italy)* [1989] ICJ Rep 15.

[95] In *Amco v Indonesia*, *SOABI v Senegal* and *Klockner v Cameroon,* the tribunals rejected the incorporation theory and regarded the incorporated entities as foreign nationals on the basis of the "control test". See *Amco Asia Corporation and Others v Republic of Indonesia* (Award on Jurisdiction) (25 September 1983), 23 ILM 351, 1 ICSID Rep 389, at 14 (*'Amco v Indonesia'*); *Société Ouest-Africaine des Bétons Industriels [SOABI] v Republic of Senegal* (Decision on Jurisdiction) (1 August 1984) 2 ICSID Rep 175, at 37 (*'SOABI v Senegal'*); *Klockner Belge, SA and Klochner Handlesmaatschappij BV v Republic of Cameroon* (Award) (21 October 1983) 2 ICSID Rep 9 *('Klockner v Cameroon'*).

[96] *Tokios Tokelës v Ukraine* (Decision on Jurisdiction) (29 April 2004) 20 *ICSID Review – Foreign Investment Law Journal* 205 (2006).

[97] The decision has attracted much criticism. For example, the Tribunal's President, Prof Weil argued that the decision was inconsistent with the ICSID Convention's goal to protect 'truly international investment' and not to intervene in domestic disputes. For a detail, see Prof Prosper Weil, 'Dissenting Opinion of April 29, 2004' (2005) 20 *ICSID Review- Foreign Investment Law Journal* 245.

incorporated under the contracting party's territory (the Netherlands) enjoyed treaty protections when investing into another contracting party (Czech Republic).[98]

Another example of customary rule in the area of law that applies to disputes between a state and foreign people living in its territory is the exhaustion of local remedies rule. In the *Interhandel* case the ICJ stated that:

> "The rule that local remedies must be exhausted before international proceedings may be instituted is a well-established rule of customary international law; the rule has been generally observed in cases in which a State has adopted the cause of its national whose rights are claimed to have been disregarded in another State in violation of international law. Before resort may be had to an international court in such a situation, it has been considered necessary that the State where the violation occurred should have an opportunity to redress it by its own means, within the framework of its own domestic system."[99]

The rule was further developed by the ICJ in the *ELSI* case. In that case, the court rejected the US argument that the exhaustion of local remedies was unnecessary because the subject of the dispute was a breach of treaty. It held that an important principle of international law should not be rebutted unless parties in the treaty not to exhaust local remedies.[100] The US further claimed that the US itself suffered for the breach of the *Friendship, Commerce and Navigation Treaty (FCN Treaty)*, so the dispute in question is between states on the plane of international law. The court however, rejected the US submission on the ground that it had to look at the nature of the dispute, but not the relief sought. Accordingly, it held that the US claim was not based on

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[98] *Saluka Investments BV v the Czech Republic* (Partial Award) (17 March 2006), UNCITRAL Arbitration <http://ita.law.uvic.ca/documents/Saluka-PartialawardFinal.pdf > at 21 December 2007.

[99] *Interhandel* (*Switzerland v United States)* [1959] ICJ Rep 27.

[100] *Elettronica Sicula SpA (ELSI) (United States v Italy)* [1989] ICJ Rep 15, para 50.

the alleged violation of its own rights and the claim was brought on behalf of injured nationals.[101] The *ELSI* decision thus provided an important development in the rule.[102]

Like the rule of diplomatic protection, the exhaustion of local remedies rule also has been left out in the practice of investment arbitration because the use of local courts was avoided for purposes of internationalising foreign investment contracts. Modern arbitral tribunals, including both ICSID and non-ICSID tribunals, take a position enabling foreign investors to institute international arbitration directly without first going to domestic courts of the host state.[103] But a host state may still insist on the local exhaustion rule through treaty negotiation. Particularly, some BITs contain a provision requiring using domestic remedies for a certain period of time.[104]

However, the requirement of exhaustion of local remedies before bringing a claim to international arbitration may be overridden by a Most Favourable Nation (MFN) clause in an investment treaty. The issue was first addressed in *Maffezini v Spain,*[105] where the claimant invoked the MFN standard of the Argentina-Spain BIT providing for fair and equitable treatment to benefit broad dispute settlement provision contained in the Chile-Spain BIT.[106]

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[101] Ibid, para 52

[102] After the ELSI decision modifications were made in statutes of some countries. Eg, the *Third Restatement* (1989) confirmed the principle stating that:

> "Under international law, before a State can make a formal claim on behalf of a private person … that person must ordinarily exhaust domestic remedies available in the responding State… local remedies need not to be exhausted for violations of international law not involving private persons." *Restatement (Third) of the Foreign Relations Law of the United States* (1989), Part II, para 902, cmt k, p. 348.

[103] See *Lanco v Argentina* (Decision on Jurisdiction) (8 December 1998), 40 ILM 457, 469/70 (2001), para 39; *Yaung Chi Oo v Myanmir* (Award) (31 March 2003), 42 ILM 540, 547/48 (2002), para 40; *Loewen Group Inc and Raymond L Loewen v United States* of America (Award) (26 June 2003), 42 ILM 811 (2003), paras 142 et seq.

[104] *Argentina - Germany BIT,* Art 10 available <http://www.unctad.org/sections/dite/iia/docs/bits/germany_argentina_sp.pdf>; *Egypt – United Kingdom BIT,* Art 8 (1) available at <http://www.unctad.org/sections/dite/iia/docs/bits/egypt_uk.pdf>; *France- Morocco BIT,* Art 10 available at <http://www.unctad.org/sections/dite/iia/docs/bits/france_morocco_fr.pdf> at 25 January 2008.

[105] *Emilio Augustín Maffezini v Kingdom of Spain* (Decision on Jurisdiction) (25 January 2000), 40 ILM 1129 (2001).

[106] The *Argentina-Spain BIT,* at issue in that case, contained a dispute settlement clause for investment disputes provided for a six-month negotiation phase before the dispute could be submitted to the competent courts of the

There is now a string of tribunals addressing the question of the applicability of MFN clauses to dispute settlement arrangement, but the tribunals have been divided over the issue.[107]

Furthermore, it has been shown by some academics that certain rules such as rules on the minimum standard for the treatment of aliens and rules on nationalisation and expropriation are beginning to develop in contemporary international law as custom.[108] But due to the persistent mutual distrust between developed and developing states, state practice in this area of law continues to differ in significant ways. Yet, for validity of customary international law, it is important that rules and principles have to be uniformly accepted by states as obligatory.[109]

Since the mid-nineteen-fifties, there has been a tension between the competing norms in the normative content of international minimum standard as a result of a newly emerging

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host State and, failing the settlement of the dispute after the expiration of a period of eighteen months, to international arbitration, whereas the *Chile-Spain BIT* did not provide for the settlement of disputes through domestic courts for a period of 18 months, but rather for international arbitration after a six-month negotiation period. The *Maffezini* tribunal held:

"… if a third-party treaty contains provisions for the settlement of disputes that are more favorable to the protection of the investor's rights and interests than those in the basic treaty, such provisions may be extended to the beneficiary of the most favored nation clause…". Ibid, para 52-56.

[107] There have been at least six ICSID tribunals: four of them supported the Maffezini ruling (*Siemens AG v Argentine Republic* (Decision on Jurisdiction) (3 August 2004), 44 ILM 138 (2005); *Camuzzi Int'l SA v Argentine Republic* (Decision on Jurisdiction) (10 June 2005) <http://ita.law.uvic.ca/documents/Camuzzi2jurisdiction.pdf > at 21 November 2007; *Gas Natural SDG, SA v Argentine Republic* (Decision on Jurisdiction) (17 June 2005) <http://ita.law.uvic.ca/documents/GasNaturalSDG-DecisiononPreliminaryQuestionsonJurisdiction.pdf > at 21 November 2007 and *Suez, Sociedad General de Aguas de Barcelona, SA and Vivendi Universal, SA v Argentine Republic* (Decision on Jurisdiction) (3 August 2006) <http://ita.law.uvic.ca/documents/SuezVivendiAWGjurisdiction.pdf> at 21 November 2007) and two tribunals rejected it (*Salini Costruttori SpA v The Hashemite Kingdom of Jordan* (Decision on Jurisdiction) (29 November 2004), 44 ILM 573 (2005) and *Plama Consortium Ltd v Republic of Bulgaria* (Decision on Jurisdiction) (8 February 2005) <http://ita.law.uvic.ca/documents/plamavbulgaria.pdf > at 21 November 2007).

Non- ICSID tribunals also split over the issue. In *Rosinvestco UK Ltd v Russian Federation* (Award on Jurisdiction), SCC Case No V079/2005) the tribunal supported the Maffezini approach, while in *Berschader & Berschader v Russian Federation* (Award on Jurisdiction), SCC Case No 080/2004 and *National Grid PLC v Argentine Republic* (Decision on Jurisdiction) (20 June 2006), UNCITRAL Arbitration, the tribunals refused to extend the MFN standard to the dispute settlement procedure.

[108] Christoph Schreuer, *The ICSID Convention: A Commentary* (2001) 612.

[109] As acknowledged by distinguished jurist, Jennings, "It is vital above all to keep constantly in mind that the first and essential general principle of public international law is its quality of universality; that is to say, that it be recognised as a valid and applicable law in all countries, whatever their cultural, economic, socio-political, or religious histories and traditions." See Robert Jennings, 'Universal International Law in a Multicultural World' in Dr Maarten Bos and Ian Brownlie (eds), *Liber Amicorum for The Rt. Hon. Lord Wilberforce* (1987) 39.

values and moral standards concerning, *inter alia,* developmental needs or developmental prerogatives of developing countries.[110] Even the rapidly increasing practice of bilateral investment treaties cannot help in this regard. Though the structure of the different bilateral investment treaties has a basic similarity, there is no consistency in the solutions adopted by them that could give rise to any uniform principle.

Meanwhile, it is argued that some principles contained in of the United Nations General Assembly Resolutions endorse a customary international law standard.[111] Particularly, developing states with a majority in the UN GA have called, mainly in the 1970s for the acceptance of the 1962 *Resolution on Permanent Sovereignty over Natural Resources*[112] as a customary rule. Other legal and political declarations of this period such as the *Declaration on the New International Economic Order*[113] and the *Charter of Economic Rights and Duties of States*[114] also may be regarded as customary law, as these resolutions represent voices of a large number of states compare with its rejection by individual arbitrators or publicists.

Lastly, one should note another weakness of customary rule. From the positivist view of international law, not all custom binds states. The recognition of custom as a binding rule depends on the will of the state concerned. In this sense, if a state expressly refused for certain duration to accept certain customs, those customs do not reflect a sense of duty in relation to

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[110] A F M Maniruzzaman, 'International Development Law as Applicable Law to Economic Development Agreements: A Prognostic View' (2001) 20 *Wisconsin International Law Journa1* 1, 50.

[111] For a discussion on the binding nature of these resolutions see Ch Six, Subsection 6.2.1 (The Legal Status of the New Principles: Are They Custom?)

[112] *Permanent Sovereignty over Natural Resources,* GA Res 1803 (XVII), UN GAOR, 17th secc, 1194th plen mtg, UN Doc A/Res/1803 (XVII) (1962).

[113] *Declaration on the Establishment of a New International Economic Order,* GA Res 3201 (S-VI), UN GAOR, 6th secc, 2229th plen mtg, UN Doc A/Res/3201 (S-VI) (1974).

[114] *Charter of Economic Rights and Duties of States,* GA Res 3281 (XXIX), UN GAOR, 29th secc, UN Doc A/Res/3281 (XXIX) (1974).

that state.[115] Then, every practice of state does not become a rule of international law merely because it is widely followed. It must be deemed by states to be obligatory as a matter of law.[116]

5.2.3. GENERAL PRINCIPLES OF LAW

The third significant source of international law, though its content is difficult to reveal, is general principles of law. First of all, it is difficult to draw boundaries of general principles of law. It refers to any rules beyond national law such as generally accepted principles, principles common to several or all legal systems, rules or principles of public international law, trade usages or *lex mercatoria,* which are in whole often termed "transnational rules".[117] Therefore, in this extremely broad context, a choice of international law based on general principles of law may lead to vagueness and blindness.

Another potential weakness of general principles of law derives from the fact that norms which are said to be general principles of law are often inconsistent with each other. As a result, a very limited number of principles such as *pacta sunt servanda* and the duty to act in good faith are found as general rules accepted in most legal systems. Thus, they were often pointed out in a number of cases, where the application of international law is supported.[118]

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[115] As Prof Brownlie wrote, "... a State may contract out of custom in the process of formation. Evidence of objection must be clear and there is probably a presumption of acceptance which is to be rebutted. Whatever the theoretical underpinnings of the principle, it is well recognised by international tribunals, and in the practice of states." Ian Brownlie, *Principles of Public International Law* (4th ed, 1990) 10.

[116] The International Court of Justice had the opportunity to express clearly this second condition in *the North Sea Continental Shelf Case*: " ... in order to achieve this result [to become rule of international law], two conditions must be fulfilled. Not only must the acts concerned amount to a settled practice, but they must also be such, or be carried out in such a way, as to be evidence of a belief that this practice is rendered obligatory by the existence of a rule of law requiring it." *(United Kingdom v Norway)* [1969] ICJ Rep 44, para 77.

[117] Masood stated:

> "… the term "rules of law" does not so precisely refer to some definite legal system as the term "law" with its traditional connotation would have done. The result is that the term "rules of law" may open to a broader interpretation. For example, it may not only be interpreted to include one or more national legal systems, but also be stretched to cover more fluid concepts like those general principles of law recognised by civilised nations as something distinct from international law, or transnational law or the new law merchant". Archad Masood, 'Law Applicable in Arbitration of Investment Disputes under the World Bank Convention' (1973)15 *Journal of Indian Law Institute* 311, 317.

[118] See *Adriano Cardella SpA v Government of Cote d'Ivoire* (Arbitral Award) (29 August 1977), 1 ICSID Rep 283; *Klockner v United Republic of Cameroon* (Arbitral Award) (21 October 1983), 2 ICSID Rep 9.

It is true that general principles of law were one of the foundations upon which the theory of internationalisation was built. Particularly, the three arbitral decisions on petroleum concessions that created the idea of internationalisation were based on the general principles of law as the proper law of the contract. In the *Abu Dhabi case*, after declaring that the Islamic law is not sophisticated enough to deal with the matter, Lord Asquith then proceeded to apply "the principles rooted in good sense and common practice of the generality of civilized nations- a sort of modern law of the nature."[119] In the *Qatar case*, the tribunal relied on "the principle of justice, equity and good conscience".[120] Similar views were stated in third case, the *Aramco Arbitration*[121].

Several other rules also were extracted as general principles in certain arbitral awards and academic works and were used to support the necessary application of international law to state contracts. Among them are "the doctrine of acquired rights" [122] which is said to protect property rights and "the doctrine of estoppel" [123] which is said to prevent a state denying the validity of the contract once the work has commenced on its basis. Though the applicability of such claims have been advanced by the supporters of the theory of internationalization, their status as general principles of law have been disputed by other academics.[124]

Furthermore, because public international law contains no rule dealing with contracts, arbitrators, when resorting to international law, frequently fall back on principles traditionally used in private international law.[125] Thus, commercial law rules including the choice of law rules

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[119] *Petroleum Development Ltd v The Sheikh of Abu Dhabi* 18 ILR 144 (1951).

[120] *Ruler of Qatar v International Marine Oil Company* 20 ILR 534 (1953).

[121] *Saudi Arabia v Arabian American Oil Co* 27 ILR 117 (1958).

[122] On the application of the principle of acquired right in investment arbitrations, see p 111.

[123] Used in *Company Z v State Organization ABC* (1983) 8 YCA 94.

[124] For example, Sornarajah doubted the validity of regarding the principles as general principles of law in his work, *Pursuit of Nationalized Property* (1986) 113-117; 209-212.

[125] As Maniruzzaman commented, "It should be noted that with the recent developments on the international level, such as the UNDROIT Principles of International Law, some scholars have expressed a renewed hope that these principles , being the general principles of law, can be fill in the void of public international law to supply appropriate rules to govern EDAs or State contracts." Maniruzzaman, above n 110, 30.

and party autonomy are widely utilised by international investment arbitration in settling disputes between a state and a foreign investor. But from a legal point of a view, a state should not be bound by such rules of commercial law without its consent. Moreover, for quite long time there have been criticisms regarding the existence of general principles of law or *lex mercatoria.*[126] However, now one may not deny the existence of the system, rather may question its validity and effect on the particular case.

Given the evidences on the general principles of law, the application of general principles of law to contracts is deemed to be unsatisfactory option. As Chukwumerije summed up the situation,

> "The truth is that despite the attraction of the concept of general principles of law to academic writers and some arbitrators, these principles do not constitute a readily identifiable and comprehensive system of rules to regulate the complex contractual relations that are often involved in State contracts. It would seem that any principle that is indeed general to a genuinely representative selection of legal systems would often be too broad as to be unhelpful in specific cases."[127]

5.2.4. JUDICIAL DOCTRINES AND WRITINGS OF PUBLICISTS

In developed legal systems, the formal sources of law which are expressly stated in rules and adopted by high legislative organs create valid legal norms. However, due to the absence of central law making authority, international law lacks such formal sources which can readily apply. Accordingly, to supplement the scarcity of rules of international law, judicial decisions and writings of highly qualified publicists are sometimes referred to as a means of interpreting the law established in other sources. They are therefore, regarded as subsidiary sources of the law.

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[126] Kubn wrote:

> "The dispute over the question of whether such international trade law [lex mercatoria or transnational law] exists started in the 1960s and the literature on this is endless." Wolfgang Kubn, 'Express and Implied Choice of Substantive Law in the Practice of International Arbitration' in Albert Berg (ed), *Planning Efficient Arbitration Proceedings: The Law Applicable in International Arbitration* (1994) 382.

[127] Okezie Chukwumerije, *Choice of Law in International Commercial Arbitration* (1994) 164.

In the practice of ICSID arbitration, the tribunals often rely on previous ICSID decisions[128]as well as decisions of other arbitral tribunals such as the Permanent Court of Justice and of the of the International Court of Justice,[129]and the Iran-US Claims Tribunal.[130] Recently, one researcher who analysed 207 publicly available decisions, awards and orders issued by ICSID tribunals has revealed that the tribunals increasingly cite them in much the same manner that common law courts do.[131] Since 2001, the frequency of citation to ICSID case-law has increased significantly ranging in average from six to nine.[132]

But it should be acknowledged that the case law is not such reliable source of law because the application of case law depends on one's view of the prior case. In this sense, decisions of previous arbitral tribunals themselves are not always considered to be binding sources of law. Notably, the three oil arbitrations which gave birth to the theory of internationalisation departed from the previously accepted principle in prior cases that a contract between a state and a foreign private party is governed only by the municipal law of that state. Instead, the arbitrators relied on own individual opinions.

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[128] In recent years it has become very common for ICSID tribunals to cite previous decisions. Eg, the criteria used in the *Salini* (*Salini Construtorri SpA and Italstrade SpA v Morocco* (Decision on Jurisdiction) (23 July 2001), 42 ILM 609 (2003)) for defining whether foreign investment contract can be considered as investment have been followed in a number of recent cases such as *Bayindir Insaat Turism Ticaret Ve Sanyi AS v Islamic Republic of Pakistan* (Decision on Jurisdiction) (14 November 2005) <http://ita.law.uvic.ca/documents/Bayindr-jurisdiction.pdf > at 22 December 2007 and *Malaysian Historical Salvors Sdn, Bhd v The Government of Malaysia* (Decision on Jurisdiction) (17 May 2007), paras 66-68 <http://ita.law.uvic.ca/documents/MHS-jurisdiction.pdf > at 23 November 2007.

[129] See *Amco v Indonesia* (Award) (20 November 1984), 1 ICSID Rep 413, 500; (Decision on Annulment) (16 May 1986), 1 ICSID Rep 509, 520; *Klockner v Cameroon* (Award) (21 October 1983), 2 ICSID Rep 9, 63; *SPP v Egypt* (Decision on Jurisdiction II) (14 April 1988), 3 ICSID Rep 131, 142/3; (Award) (20 May 1992), 3 ICSID Rep 228, 234; *Asian Agricultural Products Ltd v Sri Lanka* (Award) (27 June 1990), 4 ICSID Rep 256, 265, 271 *('AAPL v Sri Lanka')*; *Tradex v Albania* (Award) (29 April 1999) 14 *ICSID Review- Foreign Investment Law Journal* 197, 247 (1999).

[130] For example, *Amco v Indonesia* (Award) (20 November 1984) 1 ICSID Rep 413; *SPP v Egypt* (Award) (20 May 1992), 3 ICSID Rep 229; *Tradex v Albania* (Award) (29 April 1999), 14 *ICSID Review- Foreign Investment Law Journal* 197, 232, 241, 247 (1999).

[131] Jeffrey Commission, 'Precedent in Investment Treaty Arbitration: The Empirical Backing' (2007) 24 (2) *Journal of International Arbitration* 148.

[132] Ibid, 150, *Table 4*.

Meanwhile, there have been many incidents of resolving this kind of disputes involving a consideration of public international law by private commercial arbitrators, whose decisions have little or doubtful value to accept as a precedent.[133] On the other hand, there is a danger that the establishment of different tribunals under different treaties may lead to inconsistent decisions interpreting the same standard and same situations differently.[134] Owing to these defects, it may be impossible to speak of international investment jurisprudence.

The writings of recognised publicists may provide persuasive evidence of current and prospective international law on the investigation of theories and expansive researches.[135] But, because of the politicization of the issue of foreign investment, most writing on the issue is one-sided either presenting a Western perspective or that of developing states. Such politically-biased and inaccurate publications are quite dangerous and should not be accepted as a source of law. Even so, it is not unusual for an ICSID tribunal to cite scholarly writings to support its position.[136]

5.3. Summary of Findings

This chapter examined sources of international law developed in the context of the theory of internationalisation. Conventional international law not only lacked generally accepted rules to resolve investment disputes, it could not offer foreign investors much protection. Therefore, developed states felt the need to establish a regime of protections for their nationals

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[133] Eg, *Berschader & Berschader v The Russian Federation* (Arbitration Institute of the Stockholm Chamber of Commerce). About this award see Luke Eric Peterson, 'Russia prevails in Stockholm arbitration with Belgian construction firm owners' Investment Treaty News (ITN) (August 23, 2006) <http://www.iisd.org/pdf/2006/itn_aug23_2006.pdf> at 21 December 2007.

[134] Franck describes three major sets of inconsistent decisions that have caused uncertainty about the meaning of rights in investment treaties. See Susan Franck, "The Legitimacy Crisis in investment Treaty Arbitration: Privatizing Public International Law through Inconsistent Decisions' (2005) 73 *Fordham Law Review* 1521.

[135] Currently, there is a tendency that the writings of highly qualified publicists include treatises, draft conventions and reports of the International Law Commission of the United Nations, and the reports and resolutions of non-governmental groups such as the American Society of International Law, the International Law Association, the Institute de Droit International and the American Law Institute.

[136] Eg, in *Salini* case, arbitrators often referred to E. Gaillard. See *Salini Construtorri SpA and Italstrade SpA v Morocco* (Decision on Jurisdiction) (23 July 2001), 42 ILM 609 (2003), para 52.

undertaking direct foreign investment in other countries. A whole set of rules concerning the foreign investment thus was formulated mainly through arbitral practices and treaty negotiations to provide protection for foreign investors.

Since 1960s, western capital-exporting states started to conclude BITs with individual capital-importing states to ensure the stability of the operating structure of investments made by their nationals. The legal framework that emerged in the context of BITs does not adequately address environmental and social aspects linked to foreign investment. As a result, many rights and privileges of states under international law such as states' ability to regulate in areas such as environmental protection and human health have been constrained by participation in such investment agreements. This is especially the case for developing or capital importing states as they are main recipients of foreign investment.

However, the US and Canada's experience under NAFTA made the governments to realize that excessive protections granted to TNCs may require host countries to pay compensation for adopting environmental, health and social measures. Concerned by such negative results, some developed states who traditionally have championed liberalisation and better protection of foreign investment have now sought to limit to a certain extent the rights of foreign investors. The FTA between the US and Australia which abandoned the investor-state dispute settlement provisions is the best example. The trend is also reflected in modern types of BITs as many new BITs now recognise the right of the host country to exercise regulatory powers with respect to environmental concerns of foreign investment.

In the area of foreign investment, there have not been many definite and precise customary rules apart from the rule of diplomatic protection, the rule of exhaustion of local remedies and the theory of incorporation. However, these old rules of customary international law have been excluded in the light of efforts to internationalise foreign investment contracts.

Besides, the recommendations and standards proposed by one group of states are often seen as politically-biased by other group and not adequate for accepting as international custom. As a result, there has been developed no new custom applicable to foreign investment disputes.

General principles of commercial law have been extensively applied to foreign investment disputes as international law has not elaborated special rules designed for such disputes. Since international law lacks primary sources that could apply to foreign investment contracts, international investment arbitrators often rely on subsidiary sources such as judicial and arbitral decisions and writings of highly qualified publicists. But it seems hard to make selection of such sources, because of the divergence of views in scholarly writings. Arbitral jurisprudence also lacks consistency.

CHAPTER SIX: INTERNATIONAL LAW CONCERNING ECONOMIC DEVELOPMENT

6.1. Development of New Principles Reflecting Sovereign Power

The struggle of developing countries for the right to enjoy benefits of natural resource exploitation has caused the development of new principles and rules of international law such as permanent sovereignty over natural resources, self-determination and right to development. These principles and norms, whose status has increasingly been recognised in international law have weakened the further progress of the internationalisation. These norms must now be examined.

6.1.1. CALVO DOCTRINE OR NATIONAL TREATMENT RULE

One of the earliest doctrines that was built up by developing states to fully protect their economic right to exploit their own natural resources and wealth is the so-called *Calvo doctrine.*[137]

[137] The doctrine named after the founder of the theory, Carlos Calvo (1824–1906), an Argentine diplomat and jurist.

Primarily, the doctrine was developed and supported by Latin American countries at the beginning of 20th century. To respond to abuses in the nineteenth century by western states of the right of diplomatic protection of their citizens abroad, these countries claimed that foreign investment operations are matters of domestic jurisdiction.

In this context of the *Calvo* doctrine, two requirements were imposed in relation to foreigners entering into foreign investment contracts with a host state.[138] First, a foreigner is required to waive the diplomatic protection of his home state and rights under international law, and rely solely on local remedies. Second, foreigners are not to be afforded greater rights than locals and that domestic law apply to, and local courts adjudicate, investment disputes.

Thus, the doctrine was not the mere product of competing socio-political or economic struggles in an international society, but rather it was a legal concept based on at least two rules of customary international law. In first instance, there has been a customary rule according to which a foreigner is obliged to exhaust local remedies as a prerequisite to international redress.[139] In addition, the central core of international law on foreign investment was to provide national treatment under which foreigners may be treated as favourably as nationals but are not entitled to better treatment.

The validity of the *Calvo Clause* was never fully denied in judicial decisions. The leading arbitral decision addressing the issue of validity of the clause in contracts between an alien and the host state is the *North American Dredging Company Case.*[140] In that case in order to secure the award of the contract, the claimant agreed to the inclusion of the *Calvo Clause* which reads:

> "The contractor and all persons who, as employees or in any other capacity, may be engaged in the execution of the work under this contract either directly or indirectly, shall be considered as Mexicans in all matters, within the Republic of Mexico,

[138] Donald Shea, *The Calvo Clause* (1955) 17.

[139] Jon Johnson, *The North American Free Trade Agreement: A Comprehensive Guide* (1994) 280.

[140] *North American Dredging Company of Texas (USA v United Mexican States* (1926), 4 RIAA 26.

> concerning the execution of such work and the fulfilment of this contract. They shall not claim, nor shall they have, with regard to the interests and the business connected with this contract, any other rights or means to enforce the same than those granted by the laws of the Republic to Mexicans, nor shall they enjoy any other rights than those established in favour of Mexicans. They are consequently deprived of any rights as aliens, and under no conditions shall the intervention of foreign diplomatic agents be permitted, in any matter related to this contract."[141]

The US-Mexican Claims Commission accorded to the *Calvo Clause* what has been referred to as a "rule of limited validity".[142] More specifically, the Commission held that as a part of contractual undertakings, the clause must be upheld.[143] At the same time, the Commission held that the right of diplomatic protection belongs not to a national, but to a home state, so an alien cannot deprive its government of the right of protection against breaches of international law.[144] Accordingly, the claimant was free to apply to its government for protection if the claimant's resort to Mexican tribunals resulted in a denial or delay of justice.[145] Applying these principles, the Commission found that the claimant was precluded by the *Calvo Clause* from presenting its claim to its government for a breach of contract, and dismissed its claim.[146]

However, over the last few decades the *Calvo* doctrine was rejected in light of efforts internationalising state contracts. The establishment of the ICSID arbitration as specialized investor-state arbitration made the use of local courts unnecessary. Besides, the acceptance of the Hull formula of "prompt, adequate, and effective" compensation[147] in a large number of

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[141] Ibid.

[142] Donald Shea, above n 138, 296.

[143] *North American Dredging Company of Texas (USA v United Mexican States* (1926), 4 RIAA 26, paras 4-5.

[144] Ibid, para 11.

[145] Ibid, para 15.

[146] Ibid, para. 20-21.

[147] Initially, the rule was advocated by the US Secretary of State Cordell Hull in 1932. He insisted that the expropriation of property owned by foreigners requires "prompt, adequate and effective" compensation.

BITs in the 1970s and the 1980s has become a blow for the *Calvo* doctrine which recognises the equality of nationals and aliens.

In addition, the effect of the *Calvo* doctrine has lessened within Latin America itself because the traditionally hostile attitude of Latin American countries towards international arbitration has changed significantly in the past twenty years. Mexico, a long-time proponent of the *Calvo* doctrine, for example has accepted Chapter XI of the NAFTA. Many other countries in Latin America have entered into bilateral investment treaties (BITs) taking approaches that also dramatically depart from the *Calvo* doctrine.[148]

Nevertheless, the strength of the *Calvo* doctrine may be superseded, but its ideas continued. The doctrine served as a foundation of the efforts of developing states to assert their right to control over their economies. A number of new principles and doctrines of international law further have advanced the *Calvo* doctrine and claimed for host states the right to control foreign investment operations. The *Charter of Economic Rights and Duties of States* for instance, states that disputes over compensation arising from the expropriation of foreign property "shall be settled under the domestic law of the nationalising State and by its tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States and in accordance with the principle of free choice of means."[149] Meanwhile, Schreuer recently observed that the *Calvo* style rule of local remedies is reappearing in modern international law in a number of ways.[150]

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[148] *United States-Argentina Bilateral Investment Treaty*, which entered into force in 1994, has been hailed as a model investment treaty for Latin America. The BIT represents Argentina's final abandonment of the Calvo doctrine because it provides for the settlement of investment disputes through international arbitration without prior exhaustion of local remedies See Edward Snyder, 'The Menem Revolution in Argentina: Progress towards a Hemispheric Free Trade Area' (1994) 29 *Texas International Law Journal* 95, 113.

[149] *Charter of Economic Rights and Duties of States,* Art 2, para 2 (c), GA Res 3281 (XXIX), UN GAOR, 29th secc, UN Doc A/Res/3281 (XXIX) (1974).

[150] First, some BITs require that domestic remedies must be utilized for certain period of time before the claim is brought to an international arbitration. Second, some investment contracts contain the domestic forum selection clause. Third, some tribunals have held that they have jurisdiction, but an investor should make an attempt at local

6.1.2. DOCTRINE OF PERMANENT SOVEREIGNTY OVER NATURAL RESOURCES

When ex-colonial territories got their independence, the natural resources within their territories were the only means of existence of the states economically. In this respect, it was essential to manage and control their resources and wealth by themselves. Therefore, since the early 1950s, developing countries have claimed the right of previously-colonized people to benefit from the natural resources within their territories.

This right was expressed through the principle of permanent sovereignty over natural resources as reflected in the United Nations Resolution.[151] As the first democratic international organisation that unites all states regardless of the size of their territories, civilisation, economic and political situation, the UN was the main forum for the progressive development of international law rules and their implementation. In 1958 the Commission on Permanent Sovereignty over Natural Resources was established by the General Assembly *Resolution 1314 (XIII)* which was responsible for making sessions and drafting the resolutions. [152]

However, the process of adopting this historical document was not easy and it was delayed for a certain time because of ideological struggles of developed and developing states originating from the so called north-south debate. The western world was interested in adopting mechanisms which can give foreign investors much more freedom, while developing states wanted more rights to manage their economy.[153] After all, the long debate was ended by enacting

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remedies for a violation substantive international standards. For detail see Christoph Schreuer, 'Calvo's Grandchildren: The Return of Local Remedies in Investment Arbitration' (2005) 4 (1) *The Law and Practice of International Courts and Tribunals* 1. In this regard, also see n 107 and accompanying text.

[151] *Permanent Sovereignty over Natural Resources,* GA Res 1803 (XVII), UN GAOR, 17th secc, 1194th plen mtg, UN Doc A/Res/1803 (XVII) (1962).

[152] The new Commission had nine member States chosen by the President of the UN GA on the basis of geographical distribution: Afghanistan, Chile, Guatemala, the Netherlands, the Philippines, Sweden, the USSR, the United Arab Republic (UAR) and the USA. For a report on the background and adoption of GA Res. 1314 (XIII) of 12 December 1958, see UN Doc A/AC.97/1, 12 May 1959 and UNYB 1958, at 212–14.

[153] On 5 May 1961, USSR submitted an extensive draft resolution on Permanent Sovereignty over Natural Resources. Its operative paragraph 1 spelled out in detail the discretionary rights of peoples and nations arising from permanent sovereignty, including the right to admit or to refuse establishment of foreign investment for the

the historical document that gave the principle momentum under international law in the decolonisation process.

The principle of permanent sovereignty implies the formulation of a set of rights aimed at protecting the legal capacity of sovereign states to dispose freely of natural resources. The original scope and content of the principle is very much seen in the provisions of the GA Resolution. In this resolution the GA declared:

> "The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State-concerned. The exploration, development and disposition of such resources, as well as the import of the foreign capital for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities".[154]

What is more important is that the GA Resolution tried to link the right of people of the host state to fully control their resources with the responsibility of states and the international community as well. Thus, it further declares that:

> "Violation of the right of peoples and nations to sovereignty over their natural wealth and resources is contrary to the spirit and principles of the Charter of the United Nations and hinders the development of international cooperation and the maintenance of peace." [155]

Therefore, the principle of permanent sovereignty over natural recourses implies that people of every country have a right to control fully their resources and their economies, while

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exploitation of resources; to control foreign investors in their territory, including the distribution and transfer of profits; and to carry out nationalization and expropriation measures 'without let or hindrance'. Such approach was heavily criticized by the USA and the Netherlands as being a one-sided document which disregarded the importance of international economic co-operation for development and the need of respect for rules of international law. Commission on Permanent Sovereignty over Natural Resources, ***Report of the Third Session*** in UN Doc A/AC.97/L.2, 5 May 1961; UN Doc A/AC.97/SR.25, 15 May 1961, at 3 and SR.26, 16 May 1961, at 4–5.

[154] *Permanent Sovereignty over Natural Resources,* ss 1 and 2, GA Res 1803 (XVII), UN GAOR, 17th secc, 1194th plen mtg, UN Doc A/Res/1803 (XVII) (1962).

[155] Ibid, s 7.

their governments have a primary legal obligation to respect, protect and fulfil the people's right. In other words, the principle of permanent sovereignty over natural resources is a concept of rights as well as a concept of duties. [156]

The ideas of free control of natural resources and economic activities by a state were further reaffirmed in a series of more radical Resolutions.[157] Notably, the UN *Charter on Economic Rights and Duties of States* which objective is to establish generally accepted principles and norms of international economic relations proclaims:

> "Each State has the right: To nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalizing State and by its tribunals…"[158]

According to Schachter, [159] the concept of permanent sovereignty justifies states' right to exercise control over production and distribution arrangements 'without being hampered by the international law of state responsibility'. Therefore, it would be a mistake to consider the idea of permanent sovereignty over resources as 'anachronistic nationalistic rhetoric'. Rather, it should be viewed as 'a fresh manifestation of present aspirations for self-rule and greater equality'.

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[156] Dr Shrijver analysing what kind of duties the principle of permanent sovereignty may give rise found the duties such as the exercise of permanent sovereignty for national development and the well-being of people, respect for the rights and interests of indigenous peoples, duty to cooperate for international development, sustainable use of natural resources, the equitable sharing of transboundary natural resources, respect for international law and fair treatment of foreign investors and obligations related to the right to take foreign property. Nico Shrijver, *Sovereignty over Natural Resources- Balancing Rights and Duties* (1997) 306-344.

[157] See *Declaration on the Establishment of a New International Economic Order,* GA Res 3201 (S-VI), UN GAOR, 6th secc, 2229th plen mtg, UN Doc A/Res/3201 (S-VI) (1974); *Charter of Economic Rights and Duties of States,* GA Res 3281 (XXIX), UN GAOR, 29th secc, UN Doc A/Res/3281 (XXIX) (1974).

[158] *Charter of Economic Rights and Duties of States,* Art 2 (2) (c), GA Res 3281 (XXIX), UN GAOR, 29th secc, UN Doc A/Res/3281 (XXIX) (1974).

[159] Oscar Schachter, *Sharing the World's Resources* (1977) 124 - 126.

6.1.3. PEOPLE'S RIGHT TO SELF-DETERMINATION

The next principle that supports the host state's right to control the entry and activity of aliens is the principle of self-determination. In the beginning of the new era of international law or in 1945, it was proclaimed by the *UN Charter* that peoples of a whole territory have a right to determine their political status, in particular against colonial, racist or occupying regimes. The primary goal of the proposed principle was indeed to revolt against colonial rule. It arises in the de-colonization process when the people of the area are not control of their own governance.

However, it should be noted that the idea of self-determination was not a new concept. It has historically arisen much earlier, particularly in about the fifteenth or sixteenth century when the law of nations was beginning to be thought of as law of separate entities representing nations.[160] Certainly, throughout the history of international law, the content of the notion of self-determination has been changed.[161] But the concept remains a foundation of the existence of an independent State.

In the contemporary globalising world, the principle is a fundamental human right of people freely to determine their political status and pursue their economic, social and cultural development because independence is meaningless without self-determination. When a non-self governing territory like Tibet regards the principle as a way to achieve independence, for the independent states it means that people or nation of that state can determine their political and economic policies and have full and complete sovereignty over all their natural wealth and resources.

Compared to the principle of permanent sovereignty, self-determination has a higher legal status, which means the principle of self-determination now figures among the purposes

[160] James Crawford, 'The Right of Self-Determination in International Law: Its Development and Future' in Philip Alston (ed) *People's Rights* (2001) 11. His study shows that self-determination is not purely colonial or nationalistic concept as it often claimed, rather it constitutes a right of all peoples.

[161] For the history on the right of self-determination see Crawford, ibid, 11-26.

of the *United Nations Charter* and a number of other UN documents, which have an obligatory nature. Particularly, the *International Covenants on Civil and Political Rights and on Economic, Social and Cultural Rights* affirm the principle declaring that:

> 1. All peoples have the right of self-determination. By virtue of that right they freely determine their political status and freely pursue their economic, social and cultural development.
> 2. All peoples may, for their own ends, freely dispose of their natural wealth and resources without prejudice to any obligations arising out of international economic co-operation, based upon the principle of mutual benefit, and international law. In no case may a people be deprived of its own means of subsistence. [162]

Most importantly, in the context of the self determination principle, the human rights covenants squarely recognised the right of developing states to determine status of foreign investors who operate within their territories. As the *International Covenant on Economic, Social and Cultural Rights* states;

> "Developing countries, with due regard to human rights and their national economy, may determine to what extent they would guarantee the economic rights recognized in the present Covenant to non-nationals."[163]

Furthermore, the realisation of the right of self-determination is interconnected with the concept of permanent sovereignty over natural recourses. Both principles support economic independence as a basic right of peoples and nations. As the former UN Secretary-General Boutros-Ghali indicated, both sovereignty and self-determination are principles of great value and importance and should not be in conflict, but should be complementary to and in balance

[162] *International Covenant on Civil and Political Rights (CCPR),* opened for signature 19 December1966, 999 UNTS 171, Art 1 (1) and (2) (entered into force 23 March 23 1976); *International Covenant on Economic, Social and Cultural Rights (CESCR),* opened for signature 19 December 1966, 993 UNTS 3, Art 1 (1) and (2) (entered into force 3 January 1976).

[163] *International Covenant on Economic, Social and Cultural Rights (CESCR),* opened for signature 19 December 1966, 993 UNTS 3, Art 2 (3) (entered into force 3 January 1976).

with each other.[164] But the proposals of developing states to link the provisions on the right of people to self-determination with the principle of permanent sovereignty over natural resources were also faced with strong opposition from the Western world.[165]

6.1.4. THE RIGHT TO DEVELOPMENT

The "right to development" is a more contested concept, which has sharpened the controversy between developed and developing world. Though the issue is extensively studied elsewhere there is still no consensus on the content, nature and status of the concept.[166] So far Russel Barsh noted, "Jurists from the South enumerated the possible subjects and objects of this right, while jurists from the North questioned whether it existed at all."[167]

However, in the light of considerations of international human rights, it has now widely been recognised that development is a vital step towards ensuring human rights because, when people are in poverty, it often results in denial of basic human rights. The UN *Declaration on the Right to Development*[168] characterizes development as a comprehensive economic, social, cultural and political process that aims at the constant improvement of the well-being of the entire population and of all individuals, on the basis of their active, free and meaningful participation in development and in the fair distribution of the benefits resulting there from.[169]

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164 Boutros-Ghali, *An Agenda for Peace* (1992) 9.

165 When the Commission on Human Rights adopted the paragraph regarding the right on economic self-determination on May 1952, all negative votes were made by Western states. See, Commission on Human Rights, *Report of the Eight Session* (April-June 1952) in UN Doc E/2256, 8.

166 For various considerations of the right see Laure-Helene Piron, *The Right to Development- A Review of a Current State of the Debate for the Department for International Development* (Report for the UK Department for International Development, London, 2002).

167 Russel Barsh, 'The Right to Development as a Human Right: Results of the Global Consultation' (1991) 13 *Human Rights Quarterly* 322-38.

168 *Declaration on the Right to Development*, GA Res 41/128, UN GAOR, 41st secc, 97th plen mtg, UN Doc A/Res/41/128 (1986).

169 Ibid, Annex.

Indeed, other important international legal documents also emphasize respect for human rights, better standards of living, full employment, social and economic progress as key factors in keeping peace. Notably, this was clearly expressed in Article 55 of the *UN Charter*:

> "With a view to the creation of conditions of stability and well-being which are necessary for peaceful and friendly relations among nations...the United Nations shall promote : (a) higher standards of living, full employment, and conditions of economic and social progress and development; (b) solutions of international economic, social, health, and related problems....(c) universal respect for, and observance of, human rights and fundamental freedoms for all without distinction as to race, sex, language or religion."

The concept of development is constantly changing reflecting some new trends in the international arena. One important line of the argument was that whether the right creates an international obligation on the part of developed states to provide development assistance to developing states. Such an interpretation of the concept has been resisted by the developed nations.

In fact, the *Declaration* suggests that ensuring sustainable development is already a part of general international law. In other words, both developed and developing countries should be equally responsible for it. In this regard, as the *Declaration* specified,

> "States have the ... duty to formulate ... national development policies that aim at the constant improvement of the well-being of the entire population.... States have the duty to take steps ... to formulate international development policies with a view to facilitating the full realization of the right to development.... States should take steps to eliminate obstacles to development resulting from failure to observe civil and political rights, as well as economic, social and cultural rights.... All states should promote ... international peace and ... should do their utmost to achieve ... disarmament ... [and] to ensure that ... resources released by ... disarmament ... are used for ... development.... States ... shall ensure... equality of opportunity for all in their access to basic resources, education, health services, food, housing, employment and the fair distribution of income...."[170]

[170] Ibid, Arts 4, 6, 7 and 8.

6.2. Emerging International Economic Development Law

Almost half century ago some academics promoted an idea of a specific legal system which deals with foreign investment contracts.[171] However, it was unclear what the content of the new branch of legal system is, and on what principles it must be rest on. There was even a controversy how the law can be termed. Many versions were suggested such as public international economic law or transnational law or international commercial law.

Much of the international law on foreign investment that has emerged over the last few decades is a reflection of the theory of internationalisation emphasising the protection of foreign investors. But in parallel with this development, another set of legal rules have been developed setting a dualistic normative standard in international economic relations. In other words, international law of economic development which focuses on the rights of other party of foreign investment contracts also has emerged.

Thus, it is important to examine the status of these principles and also the nature of the new branch of international law, ie the law on economic development.

6.2.1. THE LEGAL STATUS OF THE NEW PRINCIPLES: ARE THEY CUSTOM?

To be sure whether the principle of permanent sovereignty over natural resources and other new principles reflect obligatory rules, it is important to look at the legal effects of those principles. As regards the international instruments that proposed the principles, it is often claimed that a series of GA Resolutions signifies the existence of a rule of international customary law despite its non-binding nature. The claim is not just related to those resolutions

[171] For example, Prof Dupuy in *Texaco case* stated "Contracts between States and private persons, under certain conditions, come within the ambit of a particular and a new branch of international law: the international law of contracts." *Texaco v Libya* 53 ILR 309, 389 (1977). At the same time, another author claimed "the commercial law of nations which, admittedly, is in *stati nascendi* also applies to the relationship between states and private parties." F A Mann, 'Reflections on a Commercial Law of Nations' (1957) 33 *British Year Book of International Law* 20, 22-23.

on natural resources, but it also involves other important resolutions which deal with international cooperation.[172] The assurance is derived from many arguments.

Firstly, the rules contained in these resolutions were not novel concepts. The principle of permanent sovereignty over natural resources, for instance, was based on the traditional ideology of sovereign statehood. Under conventional international law, sovereign states are entitled to exercise exclusive internal jurisdiction. In the *Texaco Award* the tribunal recognised:

> "… The right of a State to nationalise is unquestionable today. It results from international customary law, established as the result of general practices considered by the international community as being the law. The exercise of the national sovereignty to nationalise is regarded as the expression of the State's territorial sovereignty. Territorial Sovereignty confers upon the State an exclusive competence to organise as it wishes the economic structures of its territory and to introduce therein any reforms which may seem desirable to it. It is an essential prerogative of sovereignty for the constitutionally authorized authorities of the State to choose and build freely an economic and social system. International law recognises that a State has this prerogative just as it has the prerogative to determine freely its political regime and its constitutional institutions".[173]

Subsequently, it was not surprising that main elements and parts of the principles of permanent sovereignty over natural resources and self-determination were also included in a number of legally binding multilateral treaties such as the two *Human Rights Covenants* (1966),[174] the *African Charter on Human and Peoples' Rights* (1981),[175] the two *Vienna Conventions on Succession of*

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[172] For instance, it is argued that the Resolution 1653(XVI) of 24 November 1961 on the prohibition of nuclear weapons demonstrates certain pre-existing customary rules of international law. See, Lord Advocate's Reference, *Transcript of Day Two Tuesday* (10 October 2000) <http://www.tridentploughshares.org/lar/larday2.php > at 18 August, 2004.

[173] *Texaco v Libyan Arab Republic* reprinted in 17 ILM (1978), 3-37, para. 59.

[174] See above n 162 and accompanying text.

[175] *African Charter on Human and Peoples' Rights (Banjul),* opened for signature 27 June 1981, OAU Doc. CAB/LEG/67/3 rev. 5, Arts 20- 22 (entered into force 21 October 1986).

States (1978 and 1983),[176] the *UN Convention on the Law of the Sea* (1982)[177] and the *Climate Change* and *Biodiversity Conventions* (1992).[178] Particularly, Article 13 of the *Vienna Convention on Succession of States in Respect of Treaties* indicates the importance of the principle of permanent sovereignty over natural resources in international law. The article states:

> "Nothing in the present Convention shall affect the principles of international law affirming the permanent sovereignty of every people and every State over its natural wealth and resources."

One of the main tasks of the GA is to explain and specify principles and rules of the *UN Charter*. The *Charter of the UN* empowers the GA to initiate studies and make recommendations for the purpose of encouraging the progressive development of international law and its codification.[179] Representing different states and offering equal opportunities for creation of a consensus on the new rules, the GA provides a global forum for multilateral discussion of important international issues. Thus, as being drafted uniformly the resolutions enacted by the GA should be granted a legitimate status and be respected.

It is noteworthy that the significance of the GA Resolutions in development and codification of international legal sources is often highlighted by international bodies. Particularly, the ICJ pointed out:

> "General Assembly resolutions, even if they are not binding, may sometimes have normative value. They can, in certain circumstances, provide evidence important for establishing the existence of a rule or the emergence of an *opinio juris*. To establish

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[176] *Vienna Convention on Succession of States in Respect of Treaties,* opened for signature 22 August 1978, 1946 UNTS 3, Art 13 (entered into force 6 November 1996); *Vienna Convention on Succession of States in Respect of States Property, Archives and Debts*, opened for signature 8 April 1983, UN Doc A/CONF.117/14 (1983), the Preamble (not yet in force).

[177] *Convention on the Law of the Sea (UNCLOS),* opened for signature 10 December 1982, 1833 UNTS 3, Part II, ss 1-2, (entered into force 16 November 1994).

[178] *Convention on Biological Diversity*, opened for signature 5 June 1992, 1760 UNTS 79, the Preamble (entered into force 29 December 1993); *Convention on Climate Change,* opened for signature 9 May 1992, 1771 UNTS 165, the Preamble (entered into force 21 March 1994).

[179] *Charter of the United Nations,* opened for signature 26 June 1945, 70 UNTS 238, Art 13 (entered into force 24 October 1945).

> whether this is true of a given General Assembly resolution, it is necessary to look at its content and the conditions of its adoption; it is also necessary to see whether an *opinio juris* exists as to its normative character. Or a series of resolutions may show the gradual evolution of the *opinio juris* required for the establishment of a new rule." [180]

Furthermore, the long lasting struggle of developing states to regard those principles as their approach towards regulation of natural resources have contributed to formation of these principles as custom.[181] No matter how developed states reject the acceptance of those rules as obligatory, for developing states, the principles reflect state practice. Under international law, if a state consistently takes a particular position on the content or meaning of international law, and acts commensurate with that position, that position or action can have a very important impact on the law's development.

Finally, in the view of some scholars[182] and also as developing states have insisted, [183] the principle of permanent sovereignty over natural resources and other principles embodied in the UN GA resolutions can be accorded the status of *jus cogens*. In principle, *jus cogens* norms constitute the higher law which can override other principles of international law. Such a view however, has been vigorously rejected by developed states. For example, the representative of the US stressed that 'instant declarations and paper resolutions did not establish customary international law, much less did they give it a peremptory character".[184]

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[180] *The Legality of the Threat of Use of Nuclear Weapons* (Advisory Opinion) [1996] ICJ, para 70.

[181] In *South West Africa Case,* Tanaka J stated:

> "the accumulation of authoritative pronouncements such as resolutions, declarations, decisions, etc., concerning the interpretation of the Charter by the competent organs of the international community can be characterized as evidence of the international custom referred to in Article 38, paragraph 1 (b)." *South West Africa (Liberia v South Africa)* [1966] ICJ Rep 6, 292.

[182] See, eg, Ian Brownlie, 'Legal Status of Natural Resourses in International Law' (1979) 163 *Hague Recueil* 25, 271.

[183] At the *Vienna Conference on Succession of States in Respect of State Property, Archives and Debts,* representatives of some developing states expressed their support for the *jus cogens* character of the principle of the permanent sovereignty over natural resources. See UN Doc A/Conf. 1171C. 1/SR 13 (1983).

[184] *United Nations Conference on the Law of Treaties,* Official Records, Eleventh Session (1969) at 102. See also the statement of the representative of Switzerland, at 103.

It can be concluded that even though the principles proclaimed in a number of the UN General Assembly resolutions may not have gained their *jus cogens* status, the principles of self-determination and permanent sovereignty over natural resources are definitely one of the widely-accepted and recognised principles of international law. Moreover, neither the significance nor the impact of the Resolutions on the evolution international legal norms is deniable.

6.2.2. MOVE TO ECONOMIC DEVELOPMENT APPROACH

The building up of new rules in relation to economic sovereignty, developmental goals of host states and the applicable standards in international economic relations have changed the very nature of international law on foreign investment. Since this new body of legal rules absorbs policy considerations for economic developments of nation states, it could appropriately be named as international law on economic development. The law has been seen as a law that creates a reasonable and equitable balance between the protection of investors' interests and the special developmental needs of developing states in order to ensure distributive justice internationally.[185] It provides contextually different normative standards based on the GA Resolutions emphasising the right of states to control their economies.[186]

The subject matter of the international law of economic development concerns many aspects of development. First of all, the humanitarian concern of economic development has certainly been the most powerful driving force in the evolution of the law of economic development. In the field of foreign investment, the humanitarian concern originally appeared in the face of conditions of human rights abuses committed by multinationals. Human rights

[185] Maniruzzaman, above n 110, 44.

[186] These resolutions have undermined the theory of internationalisation. See Oscar Schachter, 'The Evolving International Law of Development' (1976) 15 *Columbia Journal of Transnational Law* 1; Milan Bulajic, *Principles of International Development Law: Progressive Development of the Principles of International Law relating to the New International Economic Order* (1986).

violated by TNCs include violation of accepted labour standards such as those that endanger the health and safety of workers or other citizens, child labour or slave labour.[187]

To make the transnationals fully accountable for their activities, various mechanisms have been proposed by human rights activists. The first achievement was the adoption on both the regional and international levels of measures to hold multinationals accountable to democratic control. Recently, the European Parliament has passed a new resolution on the corporate social responsibility.[188] The Parliament was convinced that the increase of social and environmental responsibility by corporations, linked to the principle of corporate accountability, represented an essential element of the European social model, the EU's strategy for sustainable development, and for the purposes of meeting the social challenges of economic globalisation.

On the global level, in 2003 the United Nations Human Rights Commission in Geneva adopted the first set of comprehensive international human rights norms specifically applying to companies.[189] As a result, the issue of human rights in which historically only states had primary responsibilities now also have become central to good corporate citizenship. The norms require firms to report on their compliance with human rights, labour, environmental, consumer protection and anti-corruption laws. Companies would also be subject to periodic monitoring by UN representatives and would be held accountable for violations of these principles.

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[187] Examples of the most publicized cases involving major violations of human rights have been reported by human rights activists. For example, Human Rights Watch reported that a subsidiary enterprise of Enron in India has engaged in the violent and unlawful repression of local protestors against the undertaking of a hydro-electric project. See Human Rights Watch, "The Enron Corporation: Corporate Complicity in Human Rights Violation" (1999) <www.hrw.org/reoprts/1999/enron/index.htm> at 17 January 2003.

[188] *European Parliament Resolution of 13 March 2007 on Corporate Social Responsibility: a New Partnership (2006/2133(INI)),* OJ No C 301 E /46, 13 December 2007.

[189] *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights (the Norms)* UN Doc E/CN.4/Sub.2/2003/12/Rev.2 (2003).

The next concern of the law of economic development is the issue of environmental standards. The last few decades have witnessed growing environmental destruction mainly caused by the increased economic activities of companies and individuals. Especially foreign direct investment has been seen as a significant contributor to environment pollution such as greenhouse gas emissions, deforestation and loss of biodiversity. Therefore, environmentalists have argued for the need to introduce specific environmental clauses into international investor protection and liberalisation treaties. As a result, a number of international instruments have begun to address the linkage between the environment and FDI. Notably, Article XX of GATT (1994)[190] allows broad exceptions for environmental policies that would otherwise constitute violations of GATT principles:

> "[N]othing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures...necessary to protect human, animal or plant life or health...[or]...relating to the conservation of exhaustible natural resources...."

Another important international instrument which is more environmentally conscious is *NAFTA*. Environmental groups of the participating three countries demanded that the NAFTA architects incorporate environmental standards into the agreement. Subsequently, *NAFTA* makes a broad commitment to trade policies consistent with sustainable development and environmental protection explicitly addressing environmental issues in its preamble and in five of its 22 chapters. In the preamble of the agreement, the three signatory states agree to ``undertake [trade liberalisation] in a manner consistent with environmental protection; ... promote sustainable development; [and] strengthen the development and enforcement of environmental laws and regulations."

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[190] *General Agreement on Tariffs and Trade*, 15 April 1994, Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Legal Instruments - Results of the Uruguay Round, Annex 1A, 33 ILM 1197 (1994).

However, there has not yet developed a general consensus on these environmental standards. Various formulations have been adopted in various investment treaties, guidelines and other programmes, each depending on the scope of a given instrument and the purposes and objectives of its drafters. However, one may find several environmental standards and norms as generally applicable. First, the protection of the environment is generally referred to with respect to the responsibility of both Governments and TNCs.[191] Second, host governments retain their right to take measures to protect the environment.[192] Third, there is a set of rules that encourage multinationals to transfer environmentally sound technology and management practices to host countries.[193]

The third focus of international economic development law is the wellbeing of people. It has often been stressed that foreign investment does not automatically ensure economic and social progress.[194] Thus socio-economic development of a host state has become another important concern of international development law alongside with the human rights and environment protection. In this regard, it is now accepted that investment protection can be accorded to those investors whose activities benefit the host country.

More specifically, in ICSID case law, the requirement of a contribution to the economic development of the host state has become one of the essential characteristics of investment

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[191] *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights (the Norms)* UN Doc E/CN.4/Sub.2/2003/12/Rev.2 (2003); *Rio Declaration on Environment and Development 1992*, adopted on 14 June 1992 by the United Nations Conference on Environment and Development (UNCED), A/CONF.151/26(Vol.1).

[192] See above n 190 and the accompanying text. Also see *NAFTA,* Arts 905 and 1114; the *2003 US-Singapore FTA,* Art15.10.

[193] *Agenda 21* devoted a whole chapter to the transfer of technology, and numerous initiatives were launched to facilitate technology co-operation and transfer between developed and developing countries. See *Agenda 21,* adopted on 14 June 1992 by the United Nations Conference on Environment and Development (UNCED), A.CONF/151/26 (Vol. III), Ch 34.

[194] The United Nations Conference on Trade and Development (UNCTAD), for example pointed out that "Not all FDI is in the best interests of host countries. Some can have an adverse effect on development." UNCTAD, *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development* (1999).

qualifying under the ICSID jurisdiction.[195] This rule was first applied in the *Salini* case.[196] The tribunal here held that in order to qualify as an investment, the concerned activity should have the following elements: (a) a contribution, (b) a certain duration over which the project is implemented, (c) sharing of the operational risks and (d) a contribution to the host State's development.[197] Later cases extended the "Salini criteria". The tribunal in *Joy Mining* for example, took the view that, to qualify as an "investment," the contribution the contract made to the economic development of the host State must be "significant."[198]

Furthermore, it should be noted these concerns of international economic development law are all interrelated with each other and often implemented in one context. Consequently, some scholars have indicated a broader social, environmental and cultural conception of development.[199] In particular, Muchlinski stressed the importance of integrating economic and social issues in technology transfer instruments.

According to him, apart from the inclusion of environmental concerns in technology transfer provisions, other social issues such as "corporate social responsibility" and "human rights impact assessments" should be included in the future. One possible new area concerns the reform of the technology transfer provisions in the light of the emergent principles of corporate social responsibility, which may include respect for the development objectives of developing countries in which firms operate, as suggested by the *OECD Guidelines*. Another

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[195] There is a series of consistent cases that had developed a test to define a variety of activities to be considered as investment. The latest one is *Malaysian Historical Salvors, Sdn, Bhd v Malaysia,* where the tribunal considered seven previous cases determining the meaning of investment. See *Malaysian Historical Salvors Sdn, Bhd v The Government of Malaysia* (Decision on Jurisdiction) (17 May 2007) <http://ita.law.uvic.ca/documents/MHS-jurisdiction.pdf > at 23 November 2007.

[196] *Salini Construtorri SpA and Italstrade SpA v Morocco* (Decision on Jurisdiction) (23 July 2001), 42 ILM 609 (2003).

[197] Ibid, para. 53-58.

[198] *Joy Mining Machinery Ltd v* Arab Republic of *Egypt* (Award on Jurisdiction) (6 August 2004), 44 ILM 73 (2005), para. 53

[199] See generally Oscar Schachter, 'Human Rights and Economic Development' in Emmanuel Bello and Bola Ajibola (eds), *Essays in Honour of Judge Taslim Olawale Elias* (1992) 389-98.

possible issue relates to the use of human rights impact assessments in the examination of technology transfer transactions, aimed at determining whether the transaction in question enhances or detracts from the human rights concerns of the people affected by it.[200]

On the other hand, the growing importance of transnational business in the late decades of the 20th century and the increasing emphasis on international human rights law in the same time period led to some apparent conflicts between human rights of whole nation to development and property rights of individuals in defining which one prevails over other. International law itself does not provide a clear answer to solve the conflict.

However, the fundamental principles and norms of international law, particularly some specific rights of a peremptory nature suggest that human rights should be given more weight than property rights. For instance, Cullet, who dealt with the debate on the specific tension between intellectual property rights over drugs and the human right to health, observed that where intellectual property rights and the right to health conflict, 'international law indicates that human rights should generally take precedence". He further concluded that, "the solution giving primacy to human rights is unlikely to meet with the approval of states, and would probably not stand if it came for adjudication in a WTO context; it nevertheless seems adequate from a legal and ethical point of a view".[201]

It also has been argued by NGOs that human rights law should play an important role as applicable law in investment disputes. For instance, in *amicus curiae* brief submitted to the *Vivendi* tribunal, it was pointed out that since the primacy of human rights has been

[200] Peter Muchlinski, 'Technology Transfer: Shifting Models of Law and Development' in John Hatchard and Amanda Perry-Kessaris (eds), *Law and Development: Facing Complexity in the 21st Century* (2003) 73.

[201] Philippe Cullet, 'Patents and Health in Developing Countries' in *Law and Development: Facing Complexity in the 21th Century* (2003) 93-94.

internationally recognised, human rights law could displace investment law in two situations namely a situation of conflict of norms and a situation of necessity.[202]

6.3. Summary of Findings

The analysis within this chapter (*Chapter Six)* illustrates that, alongside the regime of protections for foreign investors which has been established over the last fifty years, another set of norms has been advocated by developing states and NGOs to enhance the power of capital-importing states in the international arena. This means that within the development of international law on foreign investment there have been two contrasting approaches. One emphasises the protection of investment, another emphasises the development needs of host states.

The very nature of international law became a source of serious controversy since the 1970s. Developing states and non-governmental organizations have advanced credible arguments to elaborate new approaches towards maintaining balance between the protection of investors and the developmental needs of developing states. In this respect, the UN GA adopted several resolutions designed to create a so-called "new international economic order". These resolutions, though having a declarative nature have resulted in the elaboration of a new set of rules and principles that assert each country's sovereign right to choose own economic system and national policies and to control over foreign investments in their territories.

The emergence of the new principles, particularly, the permanent sovereignty over natural recourses and the principle of economic self-determination, right to development as well as the enactment of code of conduct for multinationals has brought about a reversal in the nature of international law on foreign investment which once was criticized as being biased on

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[202] Center for International Environmental Law (CIEL), Amicus Curiae Brief in ICSID Case No ARB/03/19 *Suez, Sociedad General de Aguas de Barcelona, SA and Vivendi Universal, SA v The Republic of Argentina*, 4 April 2007 <http://www.ciel.org/Publications/SUEZ_Amicus_English_4Apr07.pdf> at 23 September 2007.

the side of foreign investors. In other words, as the legal recognition of the new doctrines grows, international investment law could strike a healthy balance between the legitimate commercial expectations of an investor party and the right of a host country party to pursue own economic and social development policies. Indeed, that is one of the main objectives of the law on foreign investment.

In these days, the concept of development no longer means just the adjustment of developing states' economies to economic growth of the North. Conversely it broadly refers to the promotion of human rights and protection of global environment for the welfare of people all over the world. The issue of development is thus not just a problem of developing states, but it is a major concern of the contemporary world including the developed states. Economic growth is a crucial factor in people's wellbeing and enjoyment of basic rights.

Part Five: THE AUTONOMY OF THE PARTIES IN FOREIGN INVESTMENT DISPUTES–MYTH OR FACT?

The concept of autonomy means different things in different contexts. As far as the law applicable to international contractual relations is concerned, business people are left free to choose the tribunal that will hear the dispute and also the law that will govern the merits of the dispute. In the context of state contracts, however it is unlikely that a state in its contractual relations with private persons will choose some other system of law rather than its own system of law. More than fifty years have passed since the *ICSID Convention* formally accepted the principle of party autonomy in the relationship between a state and foreign private party. The question today is whether a state or its organ can enjoy the same degree of autonomy as private parties do?

It is true that, at the time of the adoption of the convention, the drafters were challenged to grant to foreign investors rights and privileges as much as they could. The legal reality faced by arbitrators in the mid 20th century was the question of how to protect foreign investors against unilateral actions of the host state. In this sense, the principle of party autonomy served as a device to defuse the host state's interventions. However, the problem is that public agencies lack the ability to freely and voluntarily engage in economic activities and relationships as they are bound by a large number of commitments and duties. Law prescribes the manner and conditions under which a state organ operates.

The analysis undertaken within this part of the thesis (PART V) is to evaluate the notion of party autonomy in situations where a state itself is a party to the contract. It forcefully argues against the belief that state contracts in the field of foreign investment are subject to party autonomy. The first chapter of this part (*Chapter Seven)* examines the role and function of the party autonomy rule in the traditional context of conflict of laws. In doing so, it explores its

origin in the economic liberalism of the 19th century, and later its universal acceptance with the development of contractual freedom. Then, it discusses the traditional limitations imposed on party autonomy. The final section of the chapter is devoted to the alleged decline of party autonomy in considerations of social justice showing the new developments in both domestic law and international law.

The next chapter (*Chapter Eight*) analyses the choice of law approaches that have been applied by ICSID tribunals, and doctrines that impact on the choice of law issue in state contracts. First of all, it shows that the prevailing theory in ICSID arbitration towards conflict of laws is based on the view that international law must control the applicable law of state contracts. Thus the theory has significantly eroded the parties' choice of applicable law. In the next part of the section, it explores a new twist to established practice of the ICSID arbitrations by reviewing some recent cases. The final section of *Chapter Eight* reveals theoretical barriers jeopardising the chances of exercising party autonomy by a state or state organ in its contractual relationship with private parties.

CHAPTER SEVEN: THE ROLE AND FUNCTION OF PARTY AUTONOMY

7.1. The Origin and Validation of the Principle of Party Autonomy

There is no general consensus on the rise of the principle of party autonomy.[1] The actual freedom of choice of law however, came only in the early nineteenth century with the development of the notion of contractual freedom emerged from the liberal economic theories

[1] Some claim that was first articulated in the writings of the sixteenth century French jurist, Dumoulin (1501-1566). See Peter North, *Private International Law Problems in Common Law Jurisdictions* (1986) 104, n. 4. Also see Edith Friedler, 'Party Autonomy Revised: A Statutory Solution to A Choice of Law Problem' 37 *University of Kansas Law Review* 475. However, some writers particularly, Nygh, commented that the writings of Dumoulin and other scholars of the thirteenth to mid-nineteenth can show stirrings perhaps, but not the real development of a doctrine of party autonomy. Peter Nygh, *Autonomy in International Contracts* (1999) 4-7. Also see Ole Lando who shares the same opinion. Ole Lando, 'Contracts' in Lipstein (ed), *International Encyclopaedia of Comparative Law* (1976) vol III, Ch 24, 6.

in which contract, property, and individual will played a major role. Thus, party autonomy is an extension of the notion of freedom of contract.

One must however, to focus on the foundations upon which the principle of party autonomy is based before determining the suitability of the principle to state contracts. Also, restrictions that apply to the party autonomy principle should be examined.

7.1.1. THE FOUNDATIONS OF PARTY AUTONOMY

The ideology of economic liberalism promotes freedom assuming that in a free society every citizen is able to make free and rational choices according to his or her own assessment. To express and pursue their interests, individuals must be granted freedom of contract as to whether at all, with whom, and on what terms they wish to contract. A state has to protect and enforce such expressions of freedom.

From this phenomenon of freedom of contract, it follows that the parties are also able to choose a legal scheme that would suit their goals and interests. In the 1860s the English courts stated that the law applicable to a contract is the law by which the parties intended the contract to be governed.[2] The rule also was adopted by French and German legal systems.[3] Though the limits in scope of party autonomy varied in these countries, there was one common trend that the law chosen by the parties was applied.

Later, the principle was recognised by regional[4] and international[5] instruments. Understanding the need to develop rules and principles that eliminate legal barriers exist in legal

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[2] See, eg, *P&O SN Co v Shand* (1865) 3 Moo NS 272; *Lloyd v Guibert* (1865) LR 1 QB 115.

[3] For the development of this rule in France see *French (Napoleonic) Civil Code* (1804), ss 1107-34. Also for the development of choice of law rules in Germany, see Volker Triebel, 'The Choice of Law in Commercial Relations: A German Perspective' (1988) 37 *International and Comparative Law Quarterly* 935.

[4] *Rome Convention on the Law Applicable to Contractual Obligations,* opened for signature 19 June 1980, 1457 UNTS 6, Art 3 (entered into force 1 April 1991) [hereinafter *Rome Convention*]; *Inter-American Convention on the Law Applicable International Contracts,* opened for signature 17 March 1994, OAS Treaty Ser. 78, OEA/Ser. A/53, Art 7 (entered into force 15 December 1996) [hereinafter *Inter-American Convention*].

[5] *Hague Convention on Law Applicable to Contracts International Sale of Goods*, opened for signature 22 December 1986, 24 ILM 1575 (1987) (not yet in force).

systems and to support international trade and investment, most domestic legal systems now accept the principle of party autonomy as a general choice of law rule of contract law.[6] Thus, this is an undoubtedly universal principle.

The objective of party autonomy is to ensure greater efficiency, stability and predictability in international business transactions by eliminating legal uncertainty brought about by the crossing of numerous legal systems whose rules are unknown to commercial men. Party autonomy is thus a market-driven concept. It allows the parties in international commerce to select their own law and the means of dispute settlement that can provide them with the greatest utility. [7]

Though the rule of party autonomy in the choice of proper law has been widely favoured, the party choice is not totally unrestrained.[8] Historically, in attempting to balance the rights of individuals against the interests and needs of a society, states have adopted certain limitations and exceptions on the party autonomy as a way of maintaining the tension. The exceptions to party autonomy may vary from one legal system to another depending on the attitudes of relevant legal systems towards the rule. However, due to the harmonisation effect of multilateral mechanisms on private international law, the existing rules on party autonomy are

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[6] Apart from the European and American systems, this principle is also manifestly embodied in private international law of several non-European countries, for example some eastern nations, ie, China (*General Principles of the Civil Law of the People's Republic of China 1987,* Art 145*),* Japan (*Japanese Private International Law 1990,* Art 7) and Thailand (*Act on Conflict of Laws B.E. 2481 1939,* Art 13). In August 2007, China's Supreme Peoples Court issued new rules interpreting governing law of contracts. The new rules reaffirm the principle of party autonomy and the close connection method in the absence of a choice of law by parties. However, as regards foreign investment contracts, the rules require a mandatory application of Chinese law. For more see *Chinese Supreme Court Issues New Rules on Governing Laws of Contracts* (2008) Moulislegal <http://www.moulislegal.com/ChinaGoverningLaw.html at 23 March 2008.

[7] In practice, autonomy often appears in the form of a clause or agreement expressly demonstrating the choice of substantive law. In some cases, however it can be inferred from the terms of the contract or the circumstances of the case.

[8] As a general rule, party autonomy is allowed only in matters that raise no public interest or do not affect third parties. See J H Dalhuisen, *Dalhuisen on Transnational and Comparative Commercial, Fiancial and Trade law* ((3rd ed, 2007) 171.

basically the same in most countries. Three major exceptions have been developed in legal systems and these should be considered.

7.1.2. PARTY AUTONOMY IN TRADITIONAL CONTEXT: THREE MAJOR EXCEPTIONS

Exception One: Substantial or Close Connection Requirement

In the first instance, there is a logical proposition that the chosen law must have some points of contact with the contract. This limitation is based on the conventional application of conflict of law doctrines that locate the proper law of contract via its close connection to the contract.[9] Under the conventional private international law of contract, thus it was long held that the parties' choice of law could be invalid unless there was no connection between the chosen law and the relationship from which the dispute arises.[10]

However, in order to provide greater autonomy and flexibility in business-to-business transactions, that restrictive approach of traditional conflict of laws now has been abandoned. Therefore, the parties to a contract may expressly select the system of law by which it is to be governed, even to the point where they select a system of law which appears totally unconnected with the transaction giving rise to the dispute.[11]

Especially, arbitral practice tends to favour this trend, as in arbitrators' eyes an unrelated 'neutral' legal system may be more desirable and rational.[12] Also, it might be because of its consistency with emerging international norms. Both the *Inter-American Convention* and the *Rome Convention* which determine the law applicable to international contracts do not require

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[9] The close connection method of determining applicable laws has been the basic legal theory of private international law. The method has its roots in the theory of a great German scholar, Friedrich Carl von Savigny (1779-1861).

[10] Courts, not long ago, refused to enforce a choice of law clause selected with no connection with the transaction. See, eg, *Whitworth Streets Estates Ltd v James Miller and Partners* (1970) AC 583; *Campagnie Tunissienne de Navigation SA v Campagnie d'Armement Maritime SA* (1971) AC 572; *Amin Rasheed Corporation v Kuwait Insurance Co* (1984) AC 50.

[11] See, eg, Klaus Berger, *The Creeping Codification of Lex Mercatoria* (1999) 76.

[12] D J Branson and R E Wallace, 'Choosing the Substantive Law to Apply in International Commercial Arbitration' (1986) 27 *Virginia Journal of International Law* 39 at 53 et seq.

that the transaction has to bear a relation to the State or country whose law is selected.[13] According to the *Rome II Regulation*, parties are free to submit non-contractual claims to the law of their choice, so long as the chosen law is not prejudice the application of provisions of the *lex loci delicti* which cannot be derogated from by an agreement.[14]

Following the international trend, some countries are now also removing the close connection or substantial connection requirements. Particularly, the revised UCC of US has deleted the old requirement that the transaction bear a "reasonable relation" to the jurisdiction designated in non-consumer context.[15] Two American states, namely Oregon and Louisiana have enacted statutes that do not require any connection to the chosen law.[16]

In the practice of state/alien arbitration, the commentators believe that the *ICSID Convention* also provides no requirement of a reasonable connection of the transaction to the law chosen by the parties.[17] But in practice it is a very rare for parties to submit their dispute to unrelated law.[18] On the other hand, the fact that certain aspects of state/alien contractual relationship must fall within boundaries of the law of the host state because of the mandatory nature of relevant legislation impairs the assumption that the parties to state contracts are able to choose a law unrelated to their transaction. Most government contracts, especially those cases

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[13] The Conventions are actually silent about the issue, so commentators interpret it differently. See Richard Plender and Michael Wilderson, *The European Contracts Convention: The Rome Convention on the Choice of Law for Contracts* (2nd ed, 2001). They authors interpret it as the Convention does not require a substantial relationship. Other authors suggested that an absence of reasonable basis for the choice could invalidate the choice made by parties. See D A Lasoc and P A Stone, *Conflict of laws in the European Community* (1987) 358.

[14] *Council Regulation (EC) No 864/2007 of 11 July 2007 on the Law Applicable to Non-contractual Obligations, (Rome II)* OJ L199/40 31/07/2007, Arts 14 (1), (2) and (3).

[15] *Revised UCC* Section 1-301.

[16] *Louisiana Civil Code,* Art 3540; *Oregon Revised Statutes*, s 81.120

[17] Christoph Schreuer, *The ICSID Convention: A Commentary* (2001) 567.

[18] Loan contracts are usually governed by the law of a country of an international financial centre such as England or New York. See Michael Pearce, 'The 'Internationalisation' of Sovereign Loan Agreements' (1986) 3 *Journal of International Business and Law* 165. In *Oil Basins Case,* a royalty agreement concluded between BHB Ltd and Oil Basins Ltd in 1960 relating to the production of hydrocarbons from the "Blackback" field in Victoria was governed by New York law. *Oil Basins Ltd v BHP Billiton Ltd* [2006] VSC 402.

involving vulnerable economic issues of the host economy such as natural resources reflect the legitimate national interest of the host state.

Therefore, it would be theoretically unrealistic to detach those contracts from the host country's legal system. On the other hand, minerals and other natural resources are traditionally classified as immovables. Thus, it can be argued that only *lex situs* (the law of a state where the immovable is located) is applied to immovables.

Exception Two: Choice of National Law

The next limitation to party autonomy relates to the subject matter of choice of law clauses. Historically, conflicts rules must only refer to some national law. This exception is a remainder of the static position of legal positivism that nothing is legal except what the State permits. Proponents of positivism argued that a volition of contracting parties submitting themselves to the chosen law could not, and should not, be above positive law.[19] Subsequently, courts do not allow the parties to "make their own *lex contractus*". The prevailing view is that, while the parties of course, can regulate any conceivable detail of their business relationship in their contract, but their contract is not a self-sufficient regulatory scheme.[20] Every contract thus, must belong to some system of law.

However, at present such a restricted approach is in the process of changing as a number of national laws[21] and some international instruments[22] have begun to allow parties to

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[19] Nygh observed: "Party autonomy can only operate through the choice of law rule a national legal system which is that of the forum which has to consider the effectiveness of the choice. Consequently, the permissibility and the conditions of a choice of a-national law depend on the law of the forum. This provides the 'minimal link' with national law through which the parties derive their mandate to choose the applicable law." Peter Nygh, *Autonomy in International Contracts* (1999) 175.

[20] The theory of 'contracts with no governing law' has not been accepted in arbitral practice. It also raises considerable debate in theory. See Emmanual Gailard and John Savage (eds), *Fouchard Gaillard Goldman on International Commercial Arbitration* (1999) 799.

[21] See French (*New Code of Civil Procedure 1975,* Art 1496), the Netherlands (*Code of Civil Procedure 1986*, Art 14), Swiss (*Swiss Private International Law Statute 1987,* Art 187), Egypt (*Egyptian Law No. 27 of 1994*, Art 39), Mexico (*Law on Arbitration 1992,* Art 1445 (2)) and Germany (ZPO 1998, Art 1051). Two American states, Oregon and Louisiana have recently enacted choice of law provisions allowing the parties to choose the governing law rather than the

international transactions to choose general principles of law and international commercial practices. When the parties have agreed upon its application, national courts may apply *lex mercatoria* as the governing law even though they traditionally do not honour a choice of a-national law. For instance, in *Deutsche Schachtbau v Shell international Petroleum Co Ltd*,[23] the House of Lords accepted as valid an arbitration award based solely on 'internationally accepted principles of law governing contractual relations'.[24]

One must admit that the concept of general principles of law or transnational rules is a subject of heavy criticism, which makes the applicability of such principles and rules makes less effective and doubtful. In most cases, it has been attacked as being vague and not sufficiently organized to satisfy the criteria of a defined legal system.[25] In addition to this, it has been argued that the application of transnational rules may undermine interests of weaker parties or third parties as it will allow the parties to seek general principles that protect their interest.[26]

Despite such criticism, long before the adoption of the *ICSID Convention*, international arbitral tribunals of investment disputes accepted general principles of law as a possible source of

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law of state. In Oregon parties to international contracts may choose the *UNIDROIT Principles of International Commercial Contracts*. See, eg, *Oregon Revised Statute,* s 81.120.

[22] Article 28 of the 1985 *UNCITRAL Model Law on International Commercial Arbitration* provides that "the tribunal shall decide the dispute in accordance with such rules of law as are chosen by the parties". See *UNCITRAL Model Law on International Commercial Arbitration,* as adopted by the United Nations Commission on International Trade Law on 21 June 1985, UN Doc A/40/17. Also see *Inter-American Convention*, Arts 2 and 10. Unlike the *Rome Convention* and the *Hague Convention*, the *Inter-American Convention* explicitly permits for both the parties and the courts to select the *lex mercatoria* as the applicable law to international contracts.

[23] *Deutsche Schachtbau v Shell international Petroleum Co Ltd* [1990] 1 AC 295.

[24] It was stated that, by choosing the arbitration to settle their dispute, the parties "have left proper law to be decided by the arbitrators and have not in terms confined the choice to national systems of law". Ibid, at 315.

[25] Goode wrote that a more serious objection against the use of *lex mercatoria* as the governing law is its indeterminacy. See Roy Goode, 'Rule, Practice, and Pragmatism in International Commercial Law' (2005) 54 *International and Comparative Law Quarterly* 552.

[26] See Gaillard and Savage, above n 20, 810 [citing Paul Lagarde, Approche critique de la lex mercatoria [Critical approach to lex mercatoria - *in French*], in: Le droit des relations économiques internationales: Études offertes à Berthold Goldman, Paris: Libraries Techniques (1982) 125 -126].

the governing law of foreign investment transactions.[27] The *Convention* contains a provision stating that "the tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties." Such broad expression of "rules of law" has been interpreted as greater party autonomy which scope is not limited to one or more national legal systems but also could be extended to general principles of law or *transnational* rules.[28]

The use of *lex mercatoria* or any other non-binding commercial law principles such as the *UNIDROIT Principles of International Commercial Contracts* of course, would ensure neutrality and protect the interests of foreign investors from the perceived shackles of national law. But as far as contracts made by a state or a state agency are concerned, general principles of law or the *lex mercatoria* is highly unsuitable for selection as the applicable law. From the theoretical standpoint, *lex mercatoria* is not such a system that can make the state contract binding because of the position of the state party as a sovereign. Practically, it is unthinkable that the state could avoid its own rules of *ordre public* by choosing some dispositive provisions like the *UNIDROIT Principles*.

Exception Three: Public Policy

The third traditional restriction imposed on the rule of party autonomy is the public policy doctrine. It is generally recognised that the law chosen by parties to international contracts will not be given effect to the extent that application of the designated law would be contrary to a fundamental policy of the State or country whose law would otherwise govern.[29] The prime objective of this rule is the protection of the justified expectations of the parties or the prevention of negative third party effects.

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[27] Refer to the Ch One for the decisions of the early arbitral tribunals where arbitrators heavily relied on a-national legal rules. The theory of internationalization based on *lex mercatoria* has led to serious scholarly debate. See generally, Muthucumaraswamy Sornarajah, *The Pursuit of Nationalized Property* (1986) Ch 2; Georges Delaume, 'The Proper Law of State Contracts and the Lex Mercatoria: A Reappraised' (1988) 3 *ICSID Review-Foreign Investment Law Journal* 79; A F M Maniruzzaman, 'The *Lex Mercatoria* and International Contracts: A Challenge for International Commercial Arbitration?' (1999) 14 (3) *American University International Law Review* 657-734.

[28] Archad Masood, 'Law Applicable in Arbitration of Investment Disputes under the World Bank Convention' (1973) 15 *Journal of Indian Law Institute* 311, 317.

[29] See, eg, *Restatement (Second) Conflict of Laws* (1971), s 187.

The public policy doctrine, as one of the key concepts in private international law, has been accepted by all major legal systems, and also some regional and international conventions, thus influencing the functioning of conflict of law rules. In private international law, the fundamental policy requirement, which legitimately restricts the free choice of law, can be expressed in the form of either public policy or mandatory rules.

There are significant differences between the public policy exception to conflicts analysis and the mandatory rules' separation of conflicts analysis. Although both public policy and mandatory rules (public law) are enforced irrespective of contrary private party agreements, they are two different conceptions. The public policy exception exclusively applies to private law and thus is one aspect of conflict analysis. On the contrary, public law regardless of whether it is mandatory or not is simply outside the scope of the traditional contractual conflict of laws.[30]

The Concept of Public Policy

There is no a precise definition of public policy. Noting a 'lack of a consensus definition of public policy' Birkland, a political scientist specializing in the study of public policy, summarized the common traits of all definitions of public policy as follows:

- The policy is made in the "public's" name;
- Policy is generally made or initiated by government;
- Policy is interpreted and implemented by public and private actors;
- Policy is what the government intends to do;
- Policy is what the government chooses not to do;[31]

Some judicial cases also address the definition of public policy. An attempt to define the public policy concept is best made in the words of Judge Goodrich, who writes that when a judge rejects the application of foreign law on public policy grounds,

[30] As Prof McConnaughay rightly defined, "the public law taboo demarcates the boundaries of conflicts analysis; the public policy exception operates within conflicts analysis". Philip McConnaughay, 'Reviving the "Public Law Taboo" in International Conflict of Laws' (1999) 35 *Stanford Journal of International Law* 255, 265.

[31] See Thomas Birkland, *An Introduction to the Policy Process* (2001) 20.

> "[I]t is not that the foreign law does not seem so reasonable to the judge as his own good homemade precedent, but it must appear 'pernicious and detestable' or, to borrow Mr Justice Cardozo's always effective language, 'violate some fundamental principle of justice, some prevalent conception of good morals, some deep-rooted tradition of the common weal".[32]

On the other hand, public policy characterizes those mandatory rules (*ie jus cogens*) which are considered as fundamental to a State and whose application may not be excluded by personal volition.[33] Thus, on the domestic level, it designates a set of fundamental perceptions of a social, cultural, moral or economic nature which are embodied in mandatory laws. Generally, courts reject the application of foreign law, if they assert that the content of that foreign law somehow violates good moral.[34]

In an international context, the notion of public policy is narrower in its scope. It primarily refers to the common interest of the international community of States.[35]Although there is no general agreement on the definition of the term "international public policy", there has been a considerable convergence of content among the various domestic expressions of international public policy.[36] In the Tamil case,[37] it was held that the expression of public policy

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[32] Nerbert Goodrich, 'Foreign Facts and Local Fancies' (1938) 25 *Virginia Law Review* 26, 33-34.

[33] Justice Byron White has said that public policy constitutes the social, economic, or political goals of a statute and regulations. *See United States v Gaubert,* 499 US 315, 323 (1981). He also said that public policy is fashioned in the legislative forum. *See Whitcomb v Chavis*, 403 US 124, 157 (1971).

[34] One of the examples of cases where the court refused the enforcement of a contractual claim on public policy grounds is *Continental Supply Co v Syndicate Trust Co,* in which the Supreme Court of North Dakota refused to enforce a stipulation in a note providing for the payment of ten percent of interest and principal for attorney's fees in the event that an attorney's services were necessary for collection. The note had been issued in Texas, 'where such stipulations are lawful, but North Dakota had a statute expressly declaring stipulations for attorney's fees "to be against public policy and vo*id*." 52 ND 209, 202 NW 404 (1924).

[35] Günther Jaenicke, 'International Public Order' in Rudolf Bernhardt (ed), *Encyclopaedia of Public International Law*, vol 2 (1995) 1349.

[36] To clarify and harmonise the understanding of the notion of international public policy, the Committee on International Commercial Arbitration of the International Law Association recommended international public policy and listed a number of principles which commonly belong to international public policy such as the principle of good faith, the prohibitions against abuse of rights and discrimination, piracy, terrorism, genocide, slavery, smuggling, drag trafficking, *pacta sunt servanda,* no expropriation without confiscation, currency controls, price fixing rules, environmental laws, tax laws, consumer protection and other laws protecting weaker parties. See International Law Association, Committee on International Commercial Arbitration, *Final Report on Public Policy as a Bar to Enforcement of International Arbitral Awards,* (New Deli Conference, 2002).

in the Indian Arbitration Act must be interpreted in the sense that the doctrine of public policy applied in the field of private international law. Thus, the enforcement of award would be refused if such enforcement would be contrary to (i) fundamental policy of Indian law or (ii) the interests of India or (iii) justice or morality.[38] The tribunal was of a view that a mere violation of the law of India does not constitute the violation of public policy.[39]

The Theory of Mandatory Rules

It is not easy to draw a clear distinction between the public policy principle and the theory of mandatory rules, because they may overlap. As it is previously said, public policy normally takes the form of a statute of the forum in ways of prohibitions and bans forbidding certain practices. Every nation has mandatory rules that govern particular transactions or relationships, which demand to be applied notwithstanding the choice of a foreign legal system. "It is the essence of mandatory rules that they defeat [any contrary] agreement of the parties."[40] Thus, it is generally accepted that a mandatory law applies irrespective of or despite the proper

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[37] In that case, a Power Purchase Agreement (PPA) was made between Tamil Nadu, the State Electricity Board for the State of Tamil Nadu and ST-CMS, an Indian incorporated company owned by investors from the US, Switzerland, and the Netherlands. The parties also entered into a separate arbitration agreement which is governed by the laws of England and the *New York Convention*. The question arose whether Indian law prohibiting the arbitration of the dispute is relevant, whether it is a matter of Indian public policy. The Tribunal held that the arbitration agreement is governed by the laws of England, thus the Indian law has no relevance and also the inarbitrability of the dispute under the Indian law is not an issue of Indian public policy. See *Tamil Nadu Electricity Board v ST-CMS Electronic Company Private Limited*, Royal Courts of Justice, Strand, London, WC2A 2LL, 16 of July 2007.

[38] Ibid, para. 43.

[39] Ibid.

[40] A J E Jaffey, '*Choice of Law in Relation to Ius Dispositivum with Particular Reference to the EEC Convention on the Law Applicable to Contractual Obligations'* in P M North (ed), *Contract Conflicts* (1982) 33, 41. Also see judicial cases eg, *Akai Case,* in which the insurance contract between disputing parties had clauses selecting English law as governing law and selecting the English courts to adjudicate the dispute. However, the High Court of Australia refused to enforce the clauses on the ground that would be contrary to a mandatory statutory provision of Insurance Contracts Act intended to protect interests of parties. *Akai Pty Ltd v The Peoples Insurance Co Ltd* (1996) 141 ALR 374, 164. Also see analogous case the *Hollandia* (1983) 1 AC 565, where the House of Lords refused to give effect to a foreign jurisdiction on the ground that it will amount to evasion of the Hague-Visby rules which the English courts were obliged to apply.

law of a contract, whether determined by a contractual choice of law clause or the conflicts rules that apply in the absence of a contractual designation.[41]

The concept of mandatory laws, therefore, has been the counterpart to the principally unlimited freedom of choice conferred to the parties by the current international mechanisms. As general rule, it is widely recognised that the courts must always apply the mandatory rules of the forum and the mandatory rules of the governing law of the contract.[42] As regards the *Rome Convention*, it provides for the application of the mandatory provisions of the law of forum country as well as the law another country with which the situation has a close connection.[43] Under the *New York Convention*, the enforcement of foreign arbitral awards can be refused on the basis that the award is contrary to public policy of the enforcement state.[44]

Most mandatory rules are usually found in public law. This subordinating aspect of public law also made most public laws mandatory. The displacement of these laws by a contractual choice is traditionally banned in both domestic and international levels because of the greater public interest reflected in the mandatory public laws. In this connection, one might need

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[41] Michael Pryles, 'Reflections on the EEC Contractual Obligations Convention - An Australian Perspective' in P M North (ed), *Contract Conflicts* (1982) 323, 331.

[42] In some cases a judge will already have several laws to consider, as well as the potential applicability of several mandatory rules. For instance, in the case of *depecage*, mandatory rules of all laws applicable to the contract must be considered.

[43] It stipulates that:

(1). When applying under this Convention the law of the country, effect may be given to the mandatory rules of the law of another country with which the situation has a close connection, if and in so far, under the law of the latter country, those rules must be applied whatever the law applicable to the contract.

(2). Nothing in this Convention shall restrict the application of the rules of the law of the forum in a situation where they are mandatory, irrespective of the law otherwise applicable to the contract. (Art 7).

[44] See *Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, opened for signature 10 June 1958, 330 UNTS 38, Art V. 2 (b) (entered into force 7 June 1959). The Convention actually provides seven exceptions (including the public policy exception) to the general rule of enforceability. Also, to clarify the public policy grounds on which courts may refuse foreign arbitral awards, the International Commercial Arbitration Committee of the International Law Association adopted Resolution on Public Policy as a Bar to Enforcement of International Arbitral Awards 2002. See 'Resolution on Public Policy as a Bar to Enforcement of International Arbitral Awards' (2003) 19 *Arbitration international* 213-215.

to distinguish mandatory public law laws from mandatory rules of private law.[45] Unlike mandatory public law rules, mandatory rules of private law are eligible for possible displacement by contractual election in a transnational context.[46] They retain their mandatory character only in a domestic setting.

In addition to the traditionally recognised exceptions to party autonomy rules, recent years have witnessed the growth of regulation of a public law nature as an additional limit of contractual freedom. Since the beginning of the last century, states promoted the welfare state policies for their citizens to shape the direction of economic activities through the use of regulation. Nowadays, the notion of social justice has become an important argument against a private legal order granting unsupervised economic relationships.

7.2. Evolution of Principles Limiting Free Choice

In domestic legal systems, the erosion of party autonomy coincides with the erosion of the general notion of freedom of contract. The basic scope of freedom of contract was quite changeable in light of discussions on the regulatory aspects of contract law in different periods of history, so did the extent of the party autonomy rule. The principle of party autonomy of contracting parties, therefore, is entirely a matter of how much a society allows private individuals the liberty and freedom to construct their relationship.

Therefore, it is necessary to examine the key milestones in the evolutionary development of individual freedom.

7.2.1. TRANSITION FROM FREE CONTRACT TO LEGISLATIVE CONTROL

[45] Nygh wrote, mandatory rules either represent the interest of a state itself (for example, exchange control laws) or private interests which the state wishes to protect (for example, in the insurance, consumption and employment contexts). See Peter Nygh, 'Reasonable Expectations of Parties in Choice of Law' (1995) 251 *Recueil des Cours* 268, 380-381.

[46] McConnaughay observed that even if private laws are mandatory in a domestic setting, the public interest in their enforcement in an international transaction is insufficient to insist on application of the law without regard for the expectations of the parties, the impact on cross-border commerce, and the comparative interests of other nations. McConnaughay, above n 30, 305.

Until the late nineteenth century economic activities were subject to few constraints. The free contract ideology primarily concerned the protection of private property presumed that individuals ought to be free to contract and own property without interference from the state. Thus it placed most bargaining beyond the purview of government.[47] Then, since the late nineteenth century, the industrialized states of the world began to move beyond *laissez-faire* liberalism towards a modern welfare state. Reforms have been adopted by the legislatures and exceptions elaborated by jurists. Textbooks also began to reflect emerging concepts of the welfare state. Nineteenth-century individualism and economic freedom that favour private rights were thus, redefined as something no longer "static", but "dynamic". [48]

What is most important to recognise, in terms of how the framework of economic liberty has been affected by the reforms, is the introduction of a comprehensive set of regulations and procedures which has precluded to some extent free bargaining between private parties.[49] Many aspects of nineteenth century private contract, therefore 'were moved over into aegis of public law'.[50] Such reforms were justified by the proponents of "positive liberty" on the

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[47] About the history of the principle of freedom of contract, see Harry Scheiber (ed), *The State and Freedom* (1998), where authors analysed the development of conceptions of economic liberty that are strongly influenced by a variety of legal principles, commercial realties, and social norms.

[48] From this period, there have been rumours of free contract's demise. Atiyah wrote in 1979 of the "decline of free choice and consent" in English law over the previous hundred years. P S Atylah, *The Rise and Fall of Freedom of Contract* (1979) 726.

[49] Especially such areas as employment, consumer purchases and tenancy were affected by the reforms. Lord Action wrote in 1881 that:

> "…in open market, between capital and labour, it cannot be right that one of two contracting parties should have the making of the laws, the management of conditions, the keeping of the peace, the administration of justice, the distribution of taxes, the control of expenditure, in its own hands, exclusively… Justice required that property should-not abdicate, but-share its political supremacy. Without this partition, free contract was … illusory. See Lord Acton, 'Letter to Mary Gladstone Apr. 24, 1881' in Alan Bullock and Maurice Shock (eds), *The Liberal Tradition from Fox to Keynes* (1956) 125-26.

[50] Harry Scheiber, 'Economic Liberty and the Modern State' in Harry Scheiber (ed), *The State and Freedom of Contract* (1998) 153.

grounds that the legislative intervention is necessary to correct the social ill and distribute wealth and goods for the benefit of all.[51]

After World War II, the concept of the "welfare state' moved to the next stage. Systems of social provision and social regulation have come to be the principal domestic undertaking of states in the Western capitalist societies leading to the expansion of regulatory controls over the markets and at the same time to more generous social spending. The primary goal of the welfare state policies was "to establish social security for all from the cradle to the grave".[52]

But in the early 1970s, the liberal policies of the growing internationalisation of the market economy have made the protectionist objectives of the welfare state increasingly incompatible with them. In the domestic context, the system of social provision came under attack as the reformers sought a system that encourages the expansion of the market economy. Particularly, the emergence of neo-liberalism and anti-welfare policies, such as the ones introduced by the Thatcher and Reagan governments after 1979 have reduced many social controls over the markets. Therefore, some argue for the fall of the welfare state.[53]

Nonetheless, the alleged decline of welfare state anyway, does not imply that the regulatory role of the state has diminished or totally disappeared. On the contrary, the idea of the welfare state traditionally dealt with providing social services to the public, has expanded because of the growth of state responsibility in other areas such as economic development and

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[51] The idea of positive liberty is often emphasized by those on the left-wing of the political spectrum. Proponents of 'positive liberty' claim that any democratic government would not be in a position to ignore the wishes of people or societies.

[52] *UK, Social Insurance and Allied Services (The Beveridge Report), Cmd. 6404* (London: HMSO, 1942).

[53] Takis Fotopoulos argued that the welfare state is no longer viable in the context of economic globalization. The current discourse of 'empowering' the citizen through ending the dependency culture functions as part of the ideology of marketisation. See Takis Fotopoulos, 'Welfare State or Economic Democracy?' (1999) 5 (3) *International Journal of Inclusive Democracy* 433.

environment management. As a result, the welfare state continues to exist in modern democratic societies.[54]

7.2.2. INCREASING CONCERNS FOR SOCIAL JUSTICE IN MODERN NATIONAL CONTRACT LAWS

The ideas of the welfare state persisted and have returned in force in later part of the twentieth century in the wave of social justice ideologies. The concept of "social justice" however, is not new. It is rather an extended variation of the traditional distributive model of social cooperation that opposes both inefficient and unjust allocation of resources. As John Rawls, the great advocate of the theory stated, social and economic inequality can only be justified when it offers the greatest possible benefit to "the worst-off in society".[55]

Today, the ideas of social justice have become an important objective behind social and economic policies of modern welfare states. Many areas of socio-economic activities are nowadays reflecting a scheme of social justice. Such trend is more notable in European legal systems. For instance, a group of scholars from various European states that worked on the construction of model principles for the regulation of contract law has proposed a manifesto for enacting social justice approaches in European contract law. [56]

In addressing fundamental questions such as how far private ordering should be permitted to regulate social and economic issues, the group put forward the following important themes.[57] First, the market order has to express a distributive objective that ensures fair treatment

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[54] The significance of this is stated by Bodo Lipple:

> "The welfare state is the historical answer to complex problems facing industrialized societies trying to achieve greater socioeconomic equality. It is a special form of state intervention which guarantees stability, certainty and reliability, conveying feeling of trust and safety to population."[54] See Bodo Lipple, 'Justice Evolution and the Welfare State in Europe' (Research Network 'European Social Policy', Amsterdam, 18-21 August 1999).

[55] John Rawls, *A Theory of Justice* (1971).

[56] Gert Brüggemeier et al (ed), 'Social Justice in European Contract Law: Manifesto' (2004) 10 (6) *European Law Journal* 653.

[57] Ibid, 664.

for every European citizen. Second, the scheme of distributive justice must be consistent with constitutional principles that establish and protect the rights of citizen. Third, these principles of social justice must acquire their legitimacy through legislation or other forms of norm creation.

Furthermore, the aforementioned manifesto reveals that modern national laws have experimented with novel solutions to ensure social justice in contract law. Particularly in national private laws, now one can discover innovations in market relations such as obligations to negotiate in good faith, to co-operate in performance, to inform the other party about material circumstances surrounding the transaction and to treat other party's interests with care.[58] Also, protection based upon social needs rather than equal opportunities and concerns of the distributive consequences of legal rules between groups are also can be found in modern private law.[59]

The so-called 'constitutionalization of private law' is another example of how European private law systems began to formulate principles of fairness in transactions.[60] The idea behind this development is that a party should no longer be guided only by his or her own interests, but also by the justified interests of the other party. [61] In this sense, a constitutionally protected right to party autonomy should be guaranteed only when it is consistent with the principle of social justice. It started when the *Bundesverfassungsgericht* (the German Constitutional Court) begun to allow the direct invocation of human rights in disputes of private rights.

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[58] Ibid, 666.

[59] Ibid.

[60] For a discussion about the trend see Olha Cherednychenko, 'The Constitutionalization of Contract Law: Something New under the Sun?' (2004) 8 (1) *Electronic Journal of Comparative Law* <http://www.ejcl.org/> at 23 January 2005; Basil Markesinis, Hannes Unberath, and Angus Johnston (eds), *The German Law of Contract : a Comparative Treatise* (2006) 37-43; Olha Cherednychenko, 'Harmonising Contract Law through Fundamental Rights?' (2007) 1 (1) *Erasmus Law Review* 37.

[61] In other words, it suggests "that private law is not in itself a closed system for the regulation of private relationships, but that it is totally subordinate to the value system of constitutional rights." See Cherednychenko, above n 60, 'The Constitutionalization of Contract Law: Something New under the Sun?', 5.

In the German *Bürgschaft* case,[62] a daughter who was 21, unemployed and owned no property had acted a surety for her father's loan of DM 100,000. The *Bundesverfassungsgericht* held that the freedom of contract, which enjoys protection as a basic right, can only justify the conclusion of risky and yet unilaterally burdensome contracts if both parties are in a position to decide freely in favour of or against being bound by a contract. This was not the case in the *Bürgschaft* situation because the bank did not inform the daughter about the inherent risks of providing surety. Accordingly, the *Bundesverfassungsgericht* ruled that the contract was contrary to general clauses of the *Bürgerliches Gesetzbuch* (the German Civil Code) concerning good morals and good faith and was therefore void.

It is evident, therefore that modern welfare states use not only regulatory public law, but also private law as a vehicle for furthering welfare objectives to reduce gross inequalities in income and raise the standard of living of their citizens. As they seek to achieve particular social and economic goals through contract law rules, national private laws that were traditionally only concerned with doing justice between private litigants, now must pursue a new goal that is to establish distributive fairness in society. Subsequently, the individual choice and freedom which are central features of contract law are no longer an absolute value.

As far as disputes where public and private interests are mixed, such as foreign investment disputes are concerned, there is even greater concern for social justice. The adoption of corporate social responsibility policies is a perfect example of how distributive and welfare concerns have influenced the legal environment. Under such policies, companies often have obligations to minimize the environment, health and safety impact of their activities and products, to respect people and communities and refrain from engaging in fraud.

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[62] See BVerfG 19 October 1993, *BVerfGE* 89, 214.

It is now necessary to examine the extent to which notions of social justice and fairness operate in the sphere of international law.

7.2.3. INTERNATIONAL LAW MOVING TOWARD SOCIAL JUSTICE

Social justice is the central organising principle of any modern national legal and economic system. However, it is a relatively new topic in the domain of international law. This absence of concepts of social justice in international law emerges from at least two factors. Firstly, the traditional international legal system was never arranged in terms of the internal affairs of sovereign states. It was responsive to the issues of peace and security of sovereign states contemplating relations among states. Second, because of the primary aim of international commercial law to reduce legal barriers for the promotion of international trade and investment, it much more secures the ideals of freedom of contract than the ideals of social justice.

However, international law today has been increasingly involved in matters that were viewed in the past as purely domestic questions.[63] More and more relations between a state and its nationals have acceded to the international legal sphere. The emergence of human rights as a subject of concern in international law in the mid-twentieth century is the example of such evolution. But the subject matter of contemporary international law is not only the protection of human rights. Far beyond that it encompasses the total well-being of human individuals. Since the early seventies, global society began to speak of economic development as a means of the eradication of poverty and the improvement of basic human dignity. Therefore, the construction of legal principles and normative standards governing issues such as socio-economic development and environmental protection became ultimately important along with the norms on protection of human rights.

[63] Nowadays it is largely accepted that international law can encompass every aspect of human life which warrants international protection of human rights.

One of the areas that has been and continues to be influenced by the new developments of international law is the field of foreign investment. In today's global economy not only developing governments, but also transnational and international financial institutions are responsible for promoting human-centred sustainable development. Under international rules regulating the behaviour of transnational corporations, corporations conducting business activities are responsible for the social and environmental impact of their activities.[64] The international financial institutions that traditionally operated in isolation from social issues also have been evaluating the social and environmental impacts of economic issues in their decision making process.[65]

This picture becomes more apparent when it comes to the field of private international law. Particularly rules of private international law, as being based on domestic law concepts, are more conscious of protecting weaker parties or third parties in contractual relationship. This is evidenced by the special protection for consumers in the *Brussels I Regulation*[66], *Lugano Convention*[67]

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[64] See for detail *the Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights (the Norms)* UN Doc E/CN.4/Sub.2/2003/12/Rev.2 (2003).

[65] Between 1990 and 1991 the World Bank first adopted two directives to stem the human rights abuses most cited in connection with the development projects in which it was involved. Similarly, the IMF acknowledged in 1995 that "the importance of social issues for sustainable economic and social development has become increasingly evident". For more about this practice see Christiana Ochoa, 'Advancing Language of Human Rights in a Global Economic Order: An Analysis of a Discourse' (2003) 23 *Boston College Third World Law Journal* 57.

[66] *Council Regulation (EC) No 44/2001 of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters* (*Brussels I Regulation*), OJ No L 012, 16/01/2001, Art 18 (entered into force on 1 March 1 2002). It applies among all the EU Member States except Denmark and replaces the *Brussels Convention* (n 68) in the mutual relations between those States to which it applies.

[67] *Lugano Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters,* opened for signature 16 September 1988, OJ No L 319, 25/11/1988, Art 13 (entered into force 1 January 1992) [hereinafter the *Lugano Convention*]. The Lugano Convention will not apply to relations among the EU Member States, but will apply where one of the 15 "old" EU Member States and certain other States in Europe is involved.

and the *Brussels Convention*[68] and the several provisions for choice of law in respect to certain consumer and employment contracts in the *Rome Convention.*[69]

Moreover, the latest developments and reconstruction in theory and practice of private international law indicate attempts to formulate new conflict of law approaches that are more responsive and suitable to the changing needs and realties of the modern economic system. For instance, the *Hague Securities Convention*[70] has established a new choice of law rule for securities held through intermediaries. The basic principle of the Convention is that where securities are held through an intermediary, the law applicable to holdings of securities is the one stated in the account agreement with intermediary.[71] The selected law will govern not only the contractual issues relating to the account agreement, but also govern proprietary issues in the absence of a provision in the agreement to the contrary.

This approach of the *Hague Convention* has been applauded and held up as a workable solution to the conflict of laws issues surrounding securities transactions held through intermediaries. Goode, for example has remarked that the approach adopted in the *Hague Convention* is a good example of a special rule which is not tied to the traditional conflicts approach and rather highly fact-specific.[72] The new approach that is founded on neither party autonomy nor traditional territorial connections[73] may be an indication that international law has

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[68] *Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters,* opened for signature 27 September 1968, OJ No L 299, 31/12/1972, Art 13 (entered into force 1 February 1973) [hereinafter the *Brussels Convention*]. Today, it has been largely superseded by the "Brussels Regulation" (n 66). It now applies only between Denmark and the other 14 old EU Member States.

[69] *Rome Convention* (n 4), *Arts* 5 and 6. The Convention will be replaced by *Regulation of the European Parliament and the of the Council on the Law Applicable to Contractual Obligations* (Rome 1), which has not been officially published yet.

[70] *Hague Convention on the Law Applicable to Certain Rights in Respect of Securities,* opened for signature 5 July 2006 available at <http://hcch.e-vision.nl/index_en.php?act=conventions.text&cid=72 > at 23 December 2007 [hereinafter the *Hague Securities Convention*].

[71] Ibid, Art 4.

[72] Goode, above n 25, 543.

[73] Rogers argues that it would be misunderstanding to describe that the approach taken in the Hague Convention is based on traditional conflict of law rules such as *lex situs* approach and a party autonomy approach. See James

acknowledged the impracticality of conventional choice of law techniques to these kind of complicated disputes which have multiple jurisdictional issues and also balancing interests of regulatory laws. The Hague approach thus makes a significant advance in thinking about conflict of laws.[74]

Furthermore, a number of international arbitral sources illustrate that the regulatory measures motivated by the public good such as the environment protection should be allowed in international investment law. In this regard, the *Methanex* award is worth highlighting. In this case, a Canadian producer of methanol brought a claim against the United States government under *NAFTA's* Chapter 11, seeking compensation of US$970 million for business lost due to "indirect expropriation."[75] The decision of this case has made two significant contributions to evolution of international investment law. Firstly, the arbitration tribunal accepted a modern regulatory approach which reflects the old police powers concept[76], an approach long argued for by civil society groups. Thus, the tribunal rejected the Methanex claim on the ground that the California ban was a public health measure, and regulatory measures that are for a public purpose are protected from being considered an expropriation.[77]

Another significance of the *Methanex Award* is its contribution to procedural developments of international investment arbitration.[78] The tribunal placed emphasis on the

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Rogers, 'Conflict of Laws for Transactions in Securities Held through Intermediaries' (2006) 39 *Cornell International Law Journal* 285.

[74] Ibid, 328.

[75] *Methanex Corporation v United States of America* (Final Award) (3 August 3 2005), 44 ILM 1345 (2005).

[76] The concept of police powers is an old international law term originated from English common law. Police power is the capacity of state to take regulatory measures in terms of public welfare, security, morality and safety. The status of the concept of police powers however, has not been firmly established in international law.

[77] The Tribunal held that:

"But as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensatory." *Methanex Corporation v United States of America* (Final Award) (3 August 3 2005), 44 ILM 1345 (2005), para 7.

[78] One author concluded:

value of greater transparency for proceedings such as these due to the involvement of public interest.[79] Such proceedings are not now, if they ever were, to be equated to the standard run of international commercial arbitration between private parties. For the first time in the history of international investment arbitration, thus the *Methanex* tribunal allowed *amicus* submissions of civil society actors in investor-state arbitration. Public hearings were also permitted by the tribunal.

The trends introduced with the *Methanex Award* already have significant implications for a treaty negotiation process. Some FTAs such as the US-Singapore FTA, the US-Chile FTA and Australia-US FTA include environment chapters which provide high environmental protection standards.[80] Regulatory actions designed to protect public health and environment no longer constitute an expropriation.[81] Meanwhile, to ensure greater transparency in proceedings of investment disputes, ICSID has made several amendments such as provisions for *amicus* submissions by third parties, public attendance at oral hearings, and publication of awards.[82] This

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"… there is no doubt that the *Methanex Case* has been pivotal in beginning the transition of international investment arbitrations from a secret and secretive process into a more transparent, accessible and thus accountable process. There is much to be done yet in this regard, but the starting line has been crossed, and it is self-evident that there is no turning back from this process in the post-Methanex era. That alone marks the Methanex arbitration as a seminal part of the evolution of international law in this field." Howard Mann, *The Final Decision in Methanex v United States: Some New Wine in Some New Bottles* (2005) International Institute for Sustainable Development <http://www.iisd.org/pdf/2005/commentary_methanex.pdf > at 23 July 2007.

[79] See *Methanex Corporation v United States of America* (Decision on Authority to Accept A*micus* Submissions) (15 January 2005) para 49 <http://www.naftaclaims.com/disputes_us_6.htm> 25 January 2007.

[80] *US-Singapore FTA,* Ch 18, available at <http://www.sice.oas.org/Trade/USA-Singapore/text_e.asp#arti18.2 >; *US-Singapore FTA,* Ch 19, available at <http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Chile_FTA/Final_Texts/asset_upload_file482_4013.pdf >; *Australia-US FTA,* Ch 19, available at <http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Australia_FTA/Final_Text/asset_upload_file819_5164.pdf > at 23 December 2007.

[81] Eg, Annex 11-B (4) (b) of the *Australia-US FTA* states:

"Except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to achieve legitimate public welfare objectives, such as the protection of public health, safety, and the environment, does not constitute indirect expropriations." *Australia-US FTA,* ibid.

[82] ICSID Convention, Regulations and Rules, Arbitration rules 32, 37 and 48 which became effective after 10 April 2006. http://www.worldbank.org/icsid/basicdoc/CRR_English-final.pdf

means that for the first time, international arbitral tribunals that used to protect the superior interests of international trade are now expected to take the public interests such as environmental or other public policy issues into account.

7.3. Summary of Findings

This chapter endeavoured to show the role and function of the principle of party autonomy in modern legal systems. It would be pertinent to reflect the origins of the principle when ideas of freedom of contract and private autonomy were warmly embraced in European society as a motivator of economic growth. As modern societies become more complex with its wide variety of perspectives, the legal atmosphere which guarantees economic liberalism has changed too.

Thus, since the late nineteenth century regulatory measures designed to establish an appropriate balance between various conflicting interests of individuals, have significantly eroded the notion of freedom. To give credibility to the necessity of these interventionist mechanisms, various theories had been developed. For instance, the legal traditions on public policy and mandatory rules were formulated to demarcate the boundaries between those matters that are subject matter of freedom of contract and those matters that are never subject to private lawmaking.

Today, in the modern market economy, the domain of individual autonomy has shrunk even more than it in the previous periods. As the discussions show, European private law systems have enacted the scheme of social justice in furthering welfare objectives. As a result, there has been a shift from private law rules that allow private parties to make their own contracts in their own terms to rules with distributive objectives. For example, the theory of 'constitutionalization of private law' that invalidates unilaterally burdensome contracts prohibits

parties from taking advantage of superior economic strength or from ignoring the justified claims of others.

The expansion of regulatory public laws into the contract regime in domestic legal systems has also resulted in the formulation of similar approaches at international law. As the study shows, both public international law and private international law have begun to accept the important role of sophisticated theories of justice in dealing with social problems. Under the influence of international human rights law, the international financial institutions that generally promote the ideology of the free market are now introducing some reforms responding to human development needs. As a result, global trade rules often served the interests of multinationals are to be changed to the benefit of poverty reduction, sustainable development and human rights.

On the other hand, there are new developments in private international law too. Most notably, in the *Methanex* case arbitrators put the public health issue before commercial interests and financial profits, and also allowed the third party participation. These could be seen as small steps towards introducing reforms to the current international law on foreign investment.

CHAPTER EIGHT: THE REALITY OF AUTONOMY IN STATE CONTRACTS

8.1. The Rule of Free Choice in the ICSID Arbitrations

As already discussed in the previous chapter,[83] the ICSID Convention gives primary importance to the choice of law made by the parties themselves. Thus, the principle of party autonomy that used to apply only to private law relationships was formally welcomed in complex and dichotomous disputes, which intertwines aspects of both public and private law. It is necessary to examine how investor/state tribunals tackle the issues.

[83] See the earlier discussions on the choice of law rules adopted by the *ICSID Convention* in Ch Three, Subsection 3.1.3 (The ICSID and the Choice of Law).

8.1.2. "SUPPLEMENTED" AND "CORRECTED" PARTY AUTONOMY

During the drafting of the World Bank's Convention, a role for international law was seen both in the case of a lacuna in national law and in the case of inconsistencies between the two laws.[84] Under this direction, on a number of occasions the international arbitral tribunals set up by the ICSID eroded the principle of free choice of law by either supplementing the parties' choice of law or correcting the choice.

The awards of two ICSID tribunals of the 1980s and the early 1990s, the ones constituted in *Letco v. Liberia*[85] and *SPP v Egypt,*[86] took the view that the parties' agreement on the applicable law has little value when it comes to the investment dispute. In both of those cases, the underlying investment agreements contained statements to the effect that they had been made "under' or 'in accordance with" certain specified legislation of the host state.[87] The Tribunal therefore was led to believe that such a reference indicated a choice by parties of national law as the law governing the concession agreement.

However, in both *Letco v Liberia* and *SPP v Egypt* the tribunals ultimately found that they did not have to decide whether or not there was any agreement between the parties on applicable law and proceeded to invoke international law, either to supplement or to correct the chosen national law. In *Letco v Liberia,* the tribunal agreed that the role of international law was to "control" or serve as a "regulator" of the applicable national law.[88] However in the case at hand,

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[84] Schreuer, above n 17, 623.

[85] *Liberian Eastern Timber Corporation (LETCO) v Government of the Republic of Liberia* (Award on Merits) (31 March 1986) 26 ILM 647 (1987) ('*Letco v Liberia*').

[86] *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt* (Award on Merits) (20 May 1992) 32 ILM 933 (1993) ('*SPP v Egypt*').

[87] In *Letco v Liberia,* the parties had entered into a concession agreement which stated that the contract had been executed under the provisions of title 15 of the Liberian Code of Laws of 1956 (26 ILM 647 (1987), at 658). In the *SPP v Egypt,* the preamble of the relevant contract made reference to three pieces of Egyptian legislation (32 ILM 933 (1993), para 75).

[88] The tribunal did not doubt as to the applicability of Liberian law as the law chosen by the parties. But instead of applying the law, it made enquires as to the applicability of international law to the current situation as if there was no choice of law made. See *Letco v Liberia,* (Award) (31 March 1986) 26 ILM 647 (1987) 658.

the tribunal declared itself satisfied that the relevant rules of Liberian Law were in conformity with those of international law.[89]

Similarly, in *SPP v Egypt*, the tribunal took the view that even when the parties had made a choice of national law, there would, because all national legal systems have gaps, always be some measure of absence of agreement between the parties on applicable law.[90] In the tribunal's view, the question whether the was choice of Egyptian law had 'very little, if any, practical significance'[91] as such a choice could not in any event 'entirely exclude the direct applicability of international law' under the second sentence of the first paragraph of Article 42 of the Convention.[92]

In another case, in *Amco v Indonesia*, the tribunal stated that, whatever the applicable national law, "applicable norms of international law must be complied with since the ICSID award has to be recognized and pecuniary obligations imposed by such award enforced, by every Contracting State of the Convention".[93] Thus, the prevalent trend of the ICSID awards suggests that international law is relevant to investment disputes as the overriding governing law even in situations where foreign investments were not made subject to it.[94] The concept has been put forward to support so-called theory of supplemental and corrective function of international

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[89] Ibid.

[90] The tribunal stated:

> "Even accepting the Respondent's view that the Parties had implicitly agreed to apply Egyptian law, such an agreement cannot entirely exclude the direct applicability of international law in certain situations. The law of the ARE [Arab Republic of Egypt], like all municipal legal systems, is not complete or exhaustive, and where a lacunae [sic] occurs it cannot be said that there is agreement as to the application of a rule of law which, *ex hypothesi*, does not exist. In such a case, it must be said that there is 'absence of agreement' and, consequently, the second sentence of Art 42 (1) [the one that provides the application of international law] would come to play." *SPP v Egypt* (Award on Merits) (20 May 1992), 32 ILM 933 (1993), para 80.

[91] Ibid, para 78.

[92] Ibid, para 80.

[93] *Amco Asia Corporation and Others v Republic of Indonesia* (Decision on Annulment) (16 May 1986), 1 ICSID Rep 513, 515 (*'Amco v Indonesia'*).

[94] Masood, above n 28, 319.

law.[95] Under this doctrine, the parties' choice of a particular domestic law could be excluded if the chosen law contradicts international rules or has gaps and relevant rules of international law would apply instead overriding the choice.

However, the adoption of the theory of supplemental and corrective effects of international law by international arbitrations other than ICSID arbitration is unlikely, primarily due to the controversies arising from the relationship between international law and municipal law. In the international context, the debate of monism versus dualism of public international has not been settled theoretically as well as practically. Thus, by simply admitting that international law controls and checks the validity of municipal law, one cannot resolve the issue and impose international law over municipal law.

From another viewpoint, the application of international law where it has not been included in the choice of law clause stipulated by the parties is very controversial. By virtue of universal private international law, a failure to mention a particular legal system in agreement amounts to a negative choice of law effectively excluding its applicability. Thus, several scholars have criticized the approach of the investment arbitrations as violating the parties' declared will.[96] Except for certain mandatory rules from which there is no escape, there is nothing that subverts or modifies the choice.

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[95] The formula is more expressly stated in the *Klockner v Cameroon Case.* Here, the Ad hoc committee held:
> "Article 42 of the Washington Convention certainly provides that "in the absence of agreement between parties, the Tribunal shall apply the law of the Contracting State party to the dispute …and such principles of international law as may be applicable. "This gives these principles (perhaps omitting cases in which it should be ascertained whether the domestic law conforms to international law) a dual role, that is, complementary (in the case of a "lacuna' in the law of the state), or corrective, should be the State's law not conform on all points to the principles of international law. In both cases, the arbitrators may have recourse to the "principles of international law" only after having inquired into and established the content of the law of the State party to the dispute… and after having applied the relevant rules of the State's law. Article 42 (1) therefore clearly does not allow the arbitrator to base his decision solely on the "rules" or "principles of international law" *Klockner Belge, SA and Klochner Handlesmaatschappij BV v Republic of Cameroon* (Decision on Annulment) (3 May 1985), 2 ICSID Rep 122.

[96] Stephen Toope, *Mixed International Arbitration: Studies in Arbitration between States and Private Persons* (1990) 238-239; Nagla Nassar, 'Internationalization of State Contracts: ICSID, The Last Citadel' (1997) 14 *Journal of International Arbitration* 185, 196; Georges Delaume, 'The Pyramids Stand: the Pharaohs can Rest in Peace' (1993) 8 *ICSID Review- Foreign Investment Law Journal* 248; A F M Maniruzzaman, 'State Contracts in Contemporary International Law: Monist versus Dualist Controversies' (2001) 12 *European Journal of International Law* 309.

Some commentators also argue that that the doctrine of supplemental and corrective effects of international law adopted by ICSID tribunals is inconsistent with the Convention itself. Notably, Maniruzzaman commented that the tribunals' approaches that suggest international law applies either as a controlling system or as performing the gap-filling function are quite dangerous and contrary to the spirit of the ICSID Convention. It may be expected that international law would apply regardless of parties' choice of law making the first sentence of Article 42 (1) meaningless.[97] Gaillard and Banifatemi also argue that the history of the negotiations leading to the conclusion of the ICSID Convention does not support the supplemental and corrective approach to international law.[98]

As a matter of fact, there are more lacunae in international law than in national law.[99] It is true today that many developing countries are enacting laws regarding natural recourses sector or investment policies, while there are no such transnational rules adopted at multilateral level due to divergent views of participants of international community. Thus, it was commented that ICSID tribunals that have been authorized to apply both national and international law have often found the application of national law alone is satisfactory without being supplemented or corrected by international law.[100]

As noted earlier, nowadays ICSID arbitrations mostly administer disputes arising out of the obligations of BITs as a majority of them mandate the resolution of disputes pursuant to the

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[97] Maniruzzaman, above n 96, 327.

[98] According to them, the intention of the negotiators was that international law should be an option available to the arbitral tribunal in the absence of an agreement between the parties. Emmanuel Gaillard and Yas Banifatemi, 'The Meaning of "and" in Article 42 (1), Second Sentence, of the Washington Convention: The Role of International Law in the ICSID Choice of Law Process' (2003) 18 *ICSID Review- Foreign Investment Law Journal* 375, 383.

[99] Gaillard pointed out, "…it is the idea that national laws contain lacunas, rather than the concept of transnational rules, that is unsound." Emmanuel Gaillard, 'Thirty years of Lex Mercatoria: Towards the Discriminating Application of Transnational Rules' in Albert Van Den Berg (ed), *Planning Efficient Arbitration Proceedings: The Law Applicable in International Arbitration* (1994) 571, 576.

[100] Ibrahim Shihata and Antonio Parra, 'Applicable Substantive Law in Disputes between States and Private Parties: The case of Arbitration under the ICSID Convention' in Albert Van Den Berg (ed), *Planning Efficient Arbitration Proceedings: The Law Applicable in International Arbitration* (1994) 294, 313.

BITs by means of arbitration. It has meant that the disputes are governed by public international law regardless of the existence of a choice of law clause in the contract. In *MTD Equity Sdn Bhd*, the tribunal interpreted the existence of the BIT as an agreement to apply international law. [101] Such an interpretation suggests that the party autonomy principle would become less important in Bilateral Investment Treaty arbitration.

8.1.2. A SHIFT TO ISSUE SPECIFIC APPROACH - CONTRACT V TREATY CLAIMS

In the context of the ICSID arbitration the most recent tendency seems to be the emergence of a new approach that deals with issues of the applicable law of investment disputes. This approach which could be termed as "an issue-specific approach" first identifies each legal issue in its proper context, then decides which law should apply to the issue.[102] The application of this approach was much clearer in *Maffezini v Spain* where the tribunal did not enter into a theoretical discussion on the law applicable to the case concerned and applied international law to matters concerning State responsibility for the question of attribution and the Spanish law to the structure and functions of an entity.[103]

The rationale for the issue specific approach is founded on the recognition of two different types of claims in investment disputes, ie contract claims and treaty claims. The trend towards the conceptual separation between contract claims and treaty claims is now found in a number of cases of the ICSID arbitration decided in 2000s. Specifically, it was first introduced in the *Vivendi I* case (2000).[104]

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[101] In that case, the tribunal found, "[t]his being a dispute under the BIT, the parties have agreed that the merits of the dispute be decided in accordance with international law." *MTD Equity Sdn Bhd & MTD Chile SA v Republic of Chile* (Award on Merits) (25 May 2004), 44 ILM 91 (2005), para 86.

[102] Christoph Schreuer, 'The Relevance of Public International Law in International Commercial Arbitration: Investment Disputes' (Paper presented at 71st Biennial Conference of the International Law Association (ILA), Berlin, 16-21 August 2004).

[103] *Maffezini (Emilio Agustin) v Kingdom of Spain* (Award) (13 November 2000), 5 ICSID Rep 419.

[104] *Compania de Aguas des Aconquija SA and Vivendi Universal v Argentine Republic,* (Award) (21 November 2000), 40 ILM 426 (2001).

The proceedings in the *Vivendi* arose from a dispute over the terms of a concession contract between a French company and its subsidiary in Argentine (CGA and CGE), on the one hand, and the Argentine Province of Tucuman, on the other hand. In the first award, the ICSID dismissed CGA and CGE's claims finding that the claims were closely linked to the performance of the concession contract, which has a forum selection clause referring to the administrative courts of Tucuman. In the tribunal's view, such claims should have been litigated before the local Tucuman courts. Also, the tribunal held that it had not been proved that there were violations of the BIT by the Argentine Republic.

In 2002 the *Ad Hoc* committee, which had to decide the on the request of CGA and CGE for the annulment of the *Vivendi I Award*, even though it found that the tribunal had exceeded its powers, also held that the tribunals' decision as to jurisdiction had been correct.[105] The committee here thus, emphasised the existence two different categories of claims which have different legal grounds and described this as follows:

> "… whether there has been a breach of the BIT and whether there has been a breach of contract are different questions. Each of these claims will be determined by reference to its own proper or applicable law- in the case of the BIT, by international law; in the case of the Concession Contract, by the proper law of the contract, in other words, the law of Tucuman."[106]

The precedent of the *Vivendi* Tribunal now has been followed in a number of awards made by the ICSID arbitration in recent years. In some of these cases, the legal questions arising from the relations between contract and treaty claims had been discussed even though the

[105] *Compania de Aguas del Aconquija, S A & Compagnie* (Decision on Annulment) (3 July 2002) 6 ICSID Rep 340, para 72.

[106] Ibid, para 96

discussions show major inconsistencies among the arbitral awards.[107] In other cases, the ICSID tribunal simply pointed out the separation of treaty claims and contractual claims.[108]

Subsequently, one may say that the principle is now well established. In *CMS v Argentina,*[109] it was acknowledged that a more pragmatic and less doctrinaire approach has emerged allowing for the application of both domestic law and international law if specific facts of the dispute so justifies. On this point, the tribunal in the case emphasized that there should no longer be any need to argue as to which of the two systems of law, namely international and domestic law superimposes one over the other, when their application depends on the particular circumstances of the case.[110]

Although the categorization of claims into treaty and contract was initially made for purposes of determining the tribunal's jurisdiction, it is equally important in determining the governing law of the issue. The categorization would classify issues as contractual or that of treaty according to their legal grounds. If the issue is based on a claim for breach of contract, it is identified as a contractual one, and then the host state's law applies. If the issue in question concerns a violation of international law standards, it is regarded as one of treaty obligations, and international law applies.

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[107] In the following cases, issues determining jurisdictions of international arbitral tribunal and domestic courts were discussed. *SGS Société Générale de Surveillance SA v Islamic Republic of Pakistan* (Decision on Jurisdiction) (6 August 2003), 8 ICSID Rep 406; *SGS Société Générale de Surveillance SA v Philippines* (Decision on Jurisdiction) (29 January 2004), 8 ICSID Rep 518; *Joy Mining Machinery Ltd v Egypt* (Decision on Jurisdiction) (6 August 2004), 19 ICSID Rev 486, 44 ILM 73 (2005); *Salini Construttori SpA v Jordan* (Decision on Jurisdiction) (9 November 2004), 44 ILM 573 (2005).

For a scholarly debate on this approach see Christoph Schreuer, 'Investment Treaty Arbitration and Jurisdiction over Contract Claims- the *Vivendi I* Case Considered' in Todd Weiler (ed), *International Investment Law and Arbitration: Leading cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (2005); Yuval Shany, 'Contract Claims vs Treaty Claims: Mapping Conflicts between ICSID Decisions on Multi-sourced Investment Claims' (2005) 99 *American Journal of International Law* 835.

[108] *Bayindir Insaat Turism Ticaret Ve Sanyi AS v Islamic Republic of Pakistan* (Decision on Jurisdiction) (14 November 2005) <http://ita.law.uvic.ca/documents/Bayindr-jurisdiction.pdf > at 22 December 2007; *Telenor Mobile Communications AS v Republic of Hungary* (Award) (13 September 2006) <http://ita.law.uvic.ca/documents/Telenorv.HungaryAward_001.pdf > at 22 December 2007.

[109] *CMS GAS Transmission Company v The Argentine Republic* (Award on Merits) (12 May 2005), 44 ILM 1205 (2005).

[110] Ibid, para 116.

On the other hand, the issue-specific approach of ICSID arbitration may introduce new uncertainties into international investment law, as some critics argue.[111] But, as far as the law applicable to investment disputes is concerned, the method may rather lessen many uncertainties that exist in the theory of internationalization. First, the method recognises that different issues might have different legal basis and therefore subject to different legal systems. Specifically, the distinctiveness of different legal domains such as domain of domestic law, domain of public international law and domain of private international law have been reaccepted. As a result, there is no point of subjecting a private contract to the rules of public international law alone.

Second, the conceptual separation between treaty and contract claims identifies those questions that should be answered by reference to public international law or treaty law and those questions that are governed by domestic law. Thus, it would assist in drawing lines between those issues within the scope of the parties' contractual autonomy and those that are not. Consequently, uncertainties related to rules of private international law such as party autonomy can be cleared up.

Furthermore, unlike the dogmatic approach based on the supplemental and corrective functions of international law, the method of the issue-specific analysis does not assign a particular role to international law in relation to domestic law. Rather, respective roles of both legal systems in resolving foreign investment disputes are of equal importance in the context of the new approach. Thus, controversies arising out of the theory of internationalization in relation to the relationship between international law and domestic law might be lessened. Meanwhile, the issue-specific approach might be deemed far more theoretically convenient than the one based on the supplementary and corrective roles of international law and even legitimate, if

[111] Eg, Shany, above n 107.

formally speaking. To this extent, the shift occurred with the recent decisions was a major one and should be welcomed.

While the problem of applying party autonomy to state contracts has not been fully settled in the practice of arbitration tribunals of investment disputes, certain doctrines also have provided obstacles to the autonomy of parties to state contracts to make free and rational choices including the choice of law that will govern the merits of their future disputes. Especially the actual freedom of a state party to the contract is constrained within the boundaries of these doctrines. It is thus necessary to discuss the application of these doctrines in state contracts.

8.2. Barriers to the Parties' Freedom of Choice of Law

Although the party autonomy rule has been considered now to be the basic choice of law rule in investment agreements, in reality it is applied only to a limited extent for a variety of reasons arising mostly from theoretical problems. The main reason of its limited application to state contracts lies in the presence of public law features of the contracts, which had been neglected to a large extent by the earlier arbitrators of investment disputes. Yet, in the area of foreign investment contracts, the fact that a state is a party to the transaction does have important consequences significantly limiting the scope of the free choice.

To examine the nature and extent of the possible application of party autonomy to cases, where a foreign sovereign is involved, related legal doctrines that impact on the choice of law issue must be identified.

8.2.1. SOVEREIGN IMMUNITY

One of the doctrines that bear on choice of law questions is the doctrine of sovereign immunity. According to the doctrine, a state or its agency who is acting in exercise of sovereign authority of the state enjoys immunity that prevents it from being sued in courts of other states.

Thus, in so far being primarily a jurisdictional rule, the doctrine restrains the freedom of parties to state contracts to bring suits in a suitable foreign state.

Initially based on the equality of states, the doctrine of sovereign immunity has undergone considerable transformations through the centuries responding to the changing priorities of society.[112] Historically, states enjoyed absolute immunity from foreign suit meaning that courts automatically dismissed suits against foreign states in respect of both their sovereign and non-sovereign actions.[113] However, by the end of the 19th century, as with US and English law, French and other civil law systems departed from the practice of granting absolute immunity and moved to a new approach which has become known as the "restrictive theory of sovereignty". This shift was motivated in large extent by the emerging role of nation-states as participants in commercial affairs.[114]

The theory of restrictive sovereignty now has been increasingly adopted in most states' court practice as well as in international practice. A regional convention, the *1972 European Convention on State Immunity (ECSI)* and statutory enactments by both the USA[115] and the UK[116] in the late 1970s recognized exceptions to immunity. Each of these Acts provide variations but the basis is that the immunity does not apply to acts regarded as commercial acts, or acts which

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[112] Hazel Fox has revealed three distinct stages in the development of the doctrine: the absolute doctrine, the restrictive doctrine and the post-modern stage. Hazel Fox, *The Law of State Immunity* (2002) 2.

[113] This position was well summarised by Lord Atkin in the *Cristina Case*:

> "The foundation for the application to set aside the writ and arrest of the ship is to be found in two propositions of international law engrafted into our domestic law which seems to me to be well established and to be beyond dispute. The first is that the courts of a country will not implead a foreign sovereign, that is, they will not by their process make him against his will a party to legal proceedings whether the proceedings involve process against his person or seek to recover from him specific property or damages. The second is that they will not by their process, whether the sovereign a party to the proceedings or not, seize or detain property of which he is in possession or control." *Cristina* (1938) AC 485 at 491.

[114] Sornarajah noted that it would be unjust that states in their dealings with foreign private persons were able to take refuge behind the principle of sovereign immunity. Muthucumaraswamy Sornarajah, *International Commercial Arbitration: The Problem of State Contracts* (1990) 200.

[115] *1976 Foreign Sovereign Immunities Act* (FSIA).

[116] *1978 State Immunity Act* (SIA).

could be performed by a private person, or acts that have a close connection with the jurisdiction of the forum state.

It is now recognised by all countries which adhere to the restrictive theory of immunity that commercial and private law acts of foreign states are not entitled to immunity. But drawing lines between immune transactions and non-immune transactions has proved more difficult because national laws classify public and private acts differently and in international law it is also not fully settled.[117] In attempting to distinguish commercial activities of a state from its public or sovereign acts, it is now agreed at least in the Europe and US that the commercial character of activities carried on by a foreign government is to be determined by reference to its "nature," rather than its "purpose."[118]

In the context of state contracts, it is accepted that the presence of an arbitration clause submitting disputes to ICSID arbitration amounts to a waiver of immunity.[119] In *Liamco*, the US district court held that by submitting arbitration, Libya waived its immunity.[120] Thus, many immunity issues, which may have an adverse effect on the conduct of the proceedings and the outcome of the award in the context of non-ICSID arbitration, may not cause much trouble when they are considered in an ICSID arbitration.

However, in practice the consent to arbitration does not automatically grant the full waiver of all types of immunity. Thus, the state involved still may raise immunity from preliminary seizure, immunity from forced execution and immunity from execution of assets.

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[117] James Crawford, 'International Law and Foreign Sovereigns: Distinguishing Immune Transactions' (1983) 54 *British Year Book of International Law* 75, 91.

[118] The application of these tests is discussed previously in Ch Two, Subsection 2.1.1 (The Methods of Determining Public Law Contract).

[119] For purposes of the ICSID Convention, consent to ICSID arbitration once it is given cannot be unilaterally revoked and constitutes on the part of the State involved an irrevocable waiver of immunity from suit. See Georges Delaume, 'Sovereign Immunity and Transnational Arbitration' (1987) 3 (1) *Arbitration International* 28.

[120] *Libyan American Oil Co ('LIAMCO') v Socialist People's Libyan Arab Jamahirya,* 482 F Supp. 1175 (DDC 1980). See also *Ipitrade Int'l, SA v Federal Republic of Nigeria,* 465 F Supp. 824 (DDC 1978), where a similar situation arose and the court held that Nigeria's agreement to arbitrate constituted a waiver of sovereign immunity.

This means a state may give consent to the consideration of an action brought against it in international arbitration or foreign court, but it may not permit to take provisional measures securing the action or to compulsory execute a judgment of the award issued against the state.[121]

Even in countries that pioneered the doctrine of restrictive sovereignty, immunity from suit and immunity from execution are left separate making the scope of immunity from execution narrower than that of jurisdictional immunity. Particularly, Subsection 1610 (a) of the *FSIA,* regarding property belonging directly to a foreign state, permits execution only narrowly, when a foreign sovereign waives its immunity from execution and the property is "in the United States" and "used for a commercial purpose in the United States".[122] Under the *SIA* of the UK, the immunity from attachment or execution is subject to two exceptions. First, the written consent of the state concerned is required and second, the property sought to be attached is 'in use or intended for use for commercial purposes." [123]

The fact that the legislation on sovereign immunity varies from jurisdiction to jurisdiction and some countries do not even have such legislation causes considerable difficulties in enforcing awards of international arbitral tribunals rendered against a defendant state. This difficulty may arise even in the case of ICSID arbitration. Delaume noted that "…in contrast with its daring approach to issues of immunity from suit, the Convention does not alter or supersede the rules of immunity from execution in Contracting States".[124]

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[121] Referring to abundant case-law authors concluded that:

> "Even where a sovereign State is properly subject to the jurisdiction of local courts [one may add the jurisdiction of arbitration tribunals], execution of any judgement against the State may not as a rule be levied against its property, unless it has separately waived its immunity from execution." See Robert Jennings and Arthur Watts (eds), *Oppenheim's International Law* (9th ed, 1992) 350.

[122] See *Connecticut Bank of Commerce v The Republic of Congo,* 309 F 3d 240, 256 (5th Cir, 2002), where the court acknowledged that the very structure of the *FSIA* creates broader jurisdiction to adjudicate than to enforce, so judgments may be rendered that are not enforceable. Also see similar decision, *De Letelier v The Republic of Chile*, 748 F 2d 790, 798-99 (2d Cir, 1984).

[123] *SIA,* ss 13 (2) (b) and 13 (3) and (4).

[124] Delaume, above n 119, 42.

Therefore, the issues of executing the final award against particular assets of the losing sovereign party still remain controversial even in the case of ICSID arbitration, although significant progress has been made in overcoming jurisdictional immunity. In other words, even if a plaintiff-foreign investor successfully obtained a final judgment against a foreign sovereign, he still may need to rely on the foreign state to pay the judgment voluntarily.[125] In this regard, it is interesting to note that the Argentine government facing with the possibility of losing in the majority of cases filed before ICSID has declared certain awards rendered under the International Centre for Settlement of Investment disputes invalid and unenforceable.[126]

8.2.2. ACT OF STATE

The next doctrine which impedes the exercise of party autonomy by parties to state contracts is the Act of State doctrine and its variations. Generally, as with the immunity principle, the Act of State doctrine never features in arbitrations between private traders. But it is not peculiar to arbitrations involving disputes arising from the administrative actions of a state. The Act of State doctrine provides that out of the respect for equality of states courts should dismiss cases that would interfere with the acts of the foreign governments done within their states' respective sovereign territory.

The Act of State doctrine has been well developed in the US and UK court practices though other jurisdictions recognise strikingly similar doctrines. *Underhill v Hernandez* was the case where the US Supreme Court first applied the Act of State doctrine. In this case the court refused to examine the legality of detention of the plaintiff, Underhill, an American citizen, by

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[125] Baldwin, Kantor and Nolan warned:

> "[S]uccessful claimants and losing respondents alike should be aware of the potential for resistance to the enforcement of ICSID awards. The limited available case law, the ICSID Convention itself and international law regarding treaties all suggest grounds for a court to refuse to enforce an ICSID award." See Edward Baldwin, Mark Kantor and Michael Nolan, 'Limits to Enforcement of ICSID Awards' (2006) 23 (1) *Journal of International Arbitration* 23.

[126] Carlos Alfaro, *Argentina: ICSID Arbitration and BITs Challenged by the Argentine Government* (2004) *Alfaro –Abogados* <www.mondaq.com> at 17 June 2006.

General Hernandez, a military commander of an insurrectionist movement which was later recognised as the government of Venezuela.

The Court reasoned:

> "[e]very sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgment on the acts of the government of another, done within its own territory."[127]

In the US, the Act of State doctrine often applies in cases where a foreign sovereign expropriated the property of an American national located in that foreign state's territory. In 1964, the US Supreme Court applied the doctrine in the famous *Sabbatino Case.*[128] The dispute arose when Cuba nationalised its sugar industry predominantly owned by US residents without compensation. The issue raised by the court was whether the doctrine is applicable in situations where an official act of another country violates international law. The court, however found that it could not question the validity of the taking of sugar by the Cuban Government even the taking was contrary to international law. It reasoned that the Executive had exclusive authority to conduct foreign affairs with other nations on behalf of the US and the Judiciary should not interfere in affairs of state. [129]

It is noteworthy that the Act of State doctrine is a more dangerous hurdle to the exercise of party autonomy by parties to state contracts than sovereign immunity for a number of reasons. Firstly, the act of state doctrine does not depend for its validity on the rules of sovereign immunity and exists independently. In other words, even if a foreign state waives its immunity by agreeing to arbitration or lawsuit in another country or a case in hand falls within any such

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[127] *Underhill v Hernandez,* 168 US 250 (1897) at 252.

[128] *Banco National de Cuba v Sabbatino*, 376 US 398 (1964).

[129] Ibid, 428-432.

exception, on the ground of the Act of State doctrine courts of one country have no power to adjudicate the validity of transactions of foreign states.[130]

Although the Act of State doctrine is statutorily abrogated in a few countries in a few narrow circumstances, the courts are still reluctant to accept such statutory limitations.[131] The basic idea is that for respect of separation of powers, the courts should refrain from making judgments that could seriously embarrass or disrupt their own country's foreign relations, relations for which its political rather than judicial branch is chiefly responsible. Thus, courts do not risk offence to foreign states.[132]

In the US jurisdictions three exceptions to this doctrine now have been recognised. The first exception applies when the executive relieves courts from any restraint upon the exercise of their jurisdiction to enquiry about the validity of the acts of a foreign state.[133] Then, Congress introduced another exception declaring that the Act of State doctrine is not applicable in case in which a taking of property violates the principles of international law.[134]A

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[130] In *Brako v Bancomer,* SNC, the court held that it has jurisdiction over the Mexican Bank pursuant to commercial activity exception; however it dismissed the plaintiff's claim because of the act of state doctrine. 762 F 2d 222 (2nd Cir, 1985). Similarly, in a English case, *Maclaine Watson v International Tin Council* it was emphasised that two principles of immunity and non-justificiability [one aspect of the act of state doctrine] had to be kept separate and concern was expressed that the *Buttes* non-justiciability principle could be used to prevent proceedings being brought against states in commercial matters, contrary to the UK *State Immunity Act 1978*. See [1988] 3 WLR 1169, 1188 per Kerr LJ.

[131] After *Sabbatino*, American Congress moved swiftly to limit the Act of State doctrine, but the judiciary has undermined the effort by narrowly interpreting the amendment and continuing to apply the doctrine wherever it does not conflict with a constrained reading of the Hickenlooper Amendment. *See* David Currie, Herma Kay and Larry Kramer, *Conflict of Laws: Cases, Comments, Questions* (2001) 811.

[132] After investigating expropriation cases decided by US Courts, Mok came to conclusion that despite the apparently illegal and injustice taking in most instances, and despite the statutory limitations, the US judiciary rarely grant relief to expropriation victims basing their decisions either on sovereign immunity or act of state doctrine. Ronald Mok, 'Expropriation Cases in United States Courts: The Act of State Doctrine, the Sovereign Immunity Doctrine, and the Foreign Sovereign Immunities Act: A Road Map for the Expropriated Victims' (1996) 8 *Pace International Law Review* 199, 235.

[133] This rule is known as the 'Bernstein letter'. *Bernstein v NV Nederlandsichre- Amerkaaniche Stoomvart Maatschappij,* 210 F 2d 375 (2nd Cir, 1954), 20 ILR 24.

[134] See 22 *USC,* s 2170 (e) (2). Cf. exception to State Immunity for takings in violation of international law in the FSIA, s. 1605 (a) (3). This exception also was introduced in response to the *Sabbatino Case.*

third exception, a treaty exception, is applied in cases, where the confiscating state is a party to a Treaty with the US prohibiting expropriation without compensation.[135]

As US law, English courts adopted the doctrine of Act of State. The first well known case is *Luther v Sagor*, where the High Court of England recognised the confiscatory decree of the Soviet government as an Act of State, thus refused to go into enquiry on the legality of the decree.[136] However, the English courts also have accepted two exceptions to the Act of State doctrine. The court will not enforce a foreign government act first, if a foreign government act is contrary to public policy of English law,[137] and second, if the foreign government act clearly violates principles of international law.[138] As regards the latter exception, the Pinochet case is an illustration of how courts may become powerless to adjudicate a foreign sovereign.[139]

Augusto Pinochet, the Chilean dictator overthrew a democratically elected socialist government led by President Salvador Allende in 1973 and took power in Chile. For seventeen years of his military dictatorship, he killed and tortured thousands of people. In 1998, at the age of 82 he was arrested in Britain on charges of torture and crimes against humanity. The High Court decided that General Pinochet was immune from any legal action in the England

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[135] See *Kalmazoo Spice Extraction Co v Provisional Military Govt of Socialist Ethiopia*, 729 F 2d 422 (6th Cir, 1984).

[136] *Luther v Sagor* [1921] 3 KB 532, 558.

[137] In *India v Taylor*, an English company operating in India voluntarily went into bankrupt in England. The English court refused tax claims of Indian Government in the winding-up the company on the ground that the enforcement of penal and fiscal laws of another country is unacceptable conduct. See *Government of India, Minister of Defense (Revenue) Division v Taylor* (1955) 1 AII ER 292, 295.

[138] In *Oppenheimer v Cattermole,* judges did not recognise the enforceability of a Nazi decree of 1941 which deprived all Jews outside Germany of German nationality on the ground that an English court will not recognise foreign legislation that constitutes a grave infringement of human rights. See *Oppenheimer v Cattermole* [1976] AC 249, 278; In the *Kuwait Airways* case, Kuwait Airlines (KAC) brought proceedings in the English court against Iraqi Airlines (IAC) for the removal and detention of aircrafts of KAC by Iraqi just after the military invasion of Kuwait by Iraqi. The English court held that Iraqi's occupation was a gross violation of international law prohibiting the use of force, thus they did not recognise the validity of Iraqi's law expropriating Kuwait's aircrafts. See *Kuwait Airways Co v Iraqi Airways Co* (No 2) [2002] UKHL 19, 16 May 2002, 114 and 138.

[139] For more about the case see Andrea Bianchi, 'The Immunity Versus Human Rights: Pinochet Case' (1999) 10 (2) *European Journal of International Law* 237.

regarding the allegations against him.[140] The House of Lords overturned the High court's judgement, but its judgement was carried by three judges to two.[141] The House of Lords' finding against sovereign immunity and the Act of State doctrine was based on the view that the *Torture Convention*,[142] which is ratified by both the UK and Chile, enables domestic courts to exercise jurisdiction over foreign governments.[143] Thus, the Act of State doctrine has very narrow limits and it is not applicable only, where the state conduct constitutes violation of *jus cogens* principles of international law.

It should be noted that the abovementioned exceptions have not been acted upon outside the US and the UK jurisdictions. In addition, the Act of State doctrine is based upon another strong ground which has internal constitutional roots. It arises out of the basic relationships between branches of government in a system of separation of powers.[144] Under the doctrine of separation of powers, the judicial branch of the government does not embarrass the political branch by questioning the validity of its acts. The act of state defence thus, justifies the competency of dissimilar institutions to make and implement particular kinds of decisions in the area of international relations.

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[140] *Regina v Evans and another Ex parte Pinochet Ugarte Regina v Bartle, Ex parte Pinochet Ugarte In re Pinochet Ugarte*, High Court Decision, QB, 28.10.98.

[141] *Regina v Bartle and the Commissioner of Police for the Metropolis and others Ex parte Pinochet, Regina v Evans and another and the Commissioner of Police for the Metropolis and others Ex parte Pinochet* , I Judgement of Lords of Appeal, 25.11.98, 37 ILM (1998) 1302. However, the first decision of the House of Lords was set aside on the ground that Lord Hoffman, who cast the deciding vote, was an unpaid director of a charity arm of Amnesty International.

[142] *Convention against Torture and Other Cruel, Inhuman and Degrading Treatment or Punishment,* opened for signature 4 February 1985, 1465 UNTS 112 (entered into force 26 June 1987) [hereinafter the *Torture Convention*].

[143] See both decisions of House of Lords concerning Pinochet's extradition. *Regina v Bartle and the Commissioner of Police for the Metropolis and others Ex parte Pinochet, Regina v Evans and another and the Commissioner of Police for the Metropolis and others Ex parte Pinochet*, Judgment of Lords of Appeal, 25.11.98, 37 ILM (1998) 1302; *R v Bow street Stipendiary Magistrate and other, ex parte Pinochet Ugarte* (Amnesty International and others intertwining) (No 3) in [1999] 2 ALL ER 97.

[144] In *South Australia v The Commonwealth* (*Railway Agreement Case*) Windeyer J observed:

> "Undertakings that are political in character-using the word "political" as referring to promises and undertakings of governments, either to their citizens or to other states or governments- are … often not enforceable by processes of law". See *South Australia v Commonwealth* (1962) 108 CLR 130, 154.

Furthermore, unlike sovereignty principle, the Act of State doctrine is not a jurisdictional rule; rather it is a special choice of law doctrine that applies to the domain of public law.[145] The doctrine restrains courts when a transaction takes place in another jurisdiction, to dismiss an action of foreign government in relation to this transaction and merely apply the law chosen in the contract. Particularly, Prof Henkin stated:

> "If there were no act of state doctrine, a domestic court in a case like Sabbatino would decide it on "conflicts" principles. It would first decide what law "governed" the issues. If under accepted choice of law principles the foreign law should govern, the court could still refuse to apply that law if it were found to be contrary to the public policy of the forum. The act of state doctrine, however, says that the foreign "law" (i.e., the act of state) must govern certain transactions and that no public policy of the forum may stand in the way." [146]

Because the doctrine constitutes a prudential doctrine of domestic law, it is commonly said that the Act of State doctrine is not mandated by public international law.[147] This cannot be true. The Act of State doctrine arose from state practice and it is a prerequisite for international peace and security. Not surprisingly, in *Sabbatino Case,* the Court held:

> "However offensive to the public policy of this country and its constituent States an expropriation of this kind may be, we conclude that both the national interest and progress toward the goal of establishing the rule of law among nations are best served by maintaining intact the act of state doctrine in this realm of its application."[148]

With respect to disputes arising out of foreign investment between states and foreign entities or corporations, the Act of State doctrine has been broadly applied by courts everywhere to expropriation of private property by a foreign government. In American law, courts generally

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[145] "It is, consequently, a judicially-developed choice-of-law rule for public law conflicts." Hans Baade (ed), *International Encyclopedia of Comparative Law* (1991) vol III, 27.

[146] Louis Henkin, 'Act of State Today: Recollections in Tranquility' (1967) 6 *Columbia Journal of Transnational Law* 175, 178.

[147] Richard Garnett, 'Foreign States and Australian Courts' (2005) 29 (3) *Melbourne University Law Review* 704.

[148] *Banco National de Cuba v Sabbatino*, 376 US 398, 437 (1964).

consider acts of nationalisation as an act of state, therefore justifiable.[149] In French courts, the examination of the validity of decrees canceling existing contracts is excluded.[150] In Italy, courts recognise a decree of a foreign state terminating a concession agreement.[151] In *Petrotimor* Case, the Australian court refused to question the validity of Petrotimor's concession granted by the Portuguese government under Portuguese law because of the Act of State doctrine.[152]

Non-western jurisdictions also accept a very similar doctrine to the question of a validity of foreign governments' expropriation act. In Japan, the Tokyo High Court held that "there is no established principle under international law for a court of a state to hold invalid the effect of the law legislated properly by a foreign state." [153] Accordingly, the plaintiff's claim for the crude oil expropriated by Iranian Government was dismissed.

However, this important judiciary principle has become obsolete in the context of international investment arbitration. In most cases, disputes between the host state and a foreign private party arise from legislative measures and international arbitral tribunals in the field of foreign investment often find these measures are unlawful on the basis of some alleged standard of international law.[154] The bulk of bilateral, regional and multilateral investment treaties nowadays prohibit the exercise of legislative or regulatory measures of the host state by their expropriation provisions.

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[149] Eg, *Sabbatino Case,* ibid. Also see *Hunt v Mobil Oil Corporation,* (1977) 550 F 2d 68; *Libyan American Oil Co ("LIAMCO") v Socialist Peoples Libyan Arab Jamahirya,* 482 F Supp 1175 (DDC 1980).

[150] See *Cohen v Credit du Nord* (1967) 47 ILR 82.

[151] See Court of Syracusa decision rejecting BP claim of ownership of oil from oilfield nationalized by Libya. *BP Exploration Company Ltd v Astro Protector Naviera SA,* (1974) 13 ILM 106.

[152] *Petrotimor Companhia de Petroleos Sarl v Commonwealth of Australia* (2003) 126 FCR 354, 369.

[153] The Tokyo High Court Judgment on 11 September 1953, Kosai Minshu, vol 6, No 11, 702.

[154] One of the earliest cases referred to this concept is the Schufeldt Claim, where arbitral tribunal rejected the legislative decree of the Guatemalan government abrogating the concession of American citizen by asserting that a sovereign cannot rely on his own municipal law to avoid arbitration. *Shufeldt Claim (US v Guatemala)*, (1930) 2 RIAA 1079.

Finally, one should note that there are many variations of the act of state doctrine, and thus even if each of them is entirely convincing by itself, together they make an bundle of arguments preventing courts from adjudicating transactions of foreign sovereign states or declaring invalid the official act of foreign sovereigns. The doctrines, which are relevant in the context of act of state, are the principle of non-justiciability, the state secrets doctrine, and the political question doctrine.[155]

8.2.3. SEVERABILITY OF PUBLIC LAW

Traditionally, only matters regulated by private law are subject to contractual autonomy, when the application of public law of state is mandatory in its geographical territory. Great international lawyers observed that "contractual freedom and mandatory national laws are different sides of the same coin; one begins where the other ends".[156] This is a well established and exceedingly comprehensive rule that is accepted by all legal systems.

For centuries, choice of law has been viewed as a tool geared to the resolution of purely private disputes. If the dispute concerns the application of foreign public law, the forum dismisses the case. Similarly, courts refuse to enforce private contractual choice of law clauses if enforcement would result in the displacement of the forum's applicable public law. The idea that public law is never amenable to conflict of laws is primarily rooted in the very nature of sovereignty.

Like a sovereign state, its public law is independent of other public law rules of any state. The application of public law rules is always limited within their scope, ie in domestic jurisdiction of each sovereign state. "Territoriality" and "nationality" have been bases of the jurisdiction

[155] In an Australian case, it was stated that provisions of the government act might not be cognizable by the courts having regard to the many "political" promises contained therein. *Commonwealth Aluminium Ltd, v Attorney-General* (1976) Qd R 231, 261. Also see recent cases of the US and the UK, eg, *Schneider v Kissinger*, 412 F 3d 190 (DC Cir, 2005); *Republic of Ecuador v Occidental Exploration and Production Co* [2005] EWCA 1116, [2006] 2 WLR 70.

[156] Bernardo Cremades and Steven Plehn, 'The New *Lex Mercatoria* and the Harmonisation of the Laws of International Commercial Transaction' (1984) *2 Boston University International Law Journal* 317, 325 n 37.

meaning that each sovereign state has the power or authority to regulate, control and govern all events and persons within its territorial limits and also its own nationals residing outside of the country.[157] Since public law of one country does not apply in another country, there has never been an issue of conflicts of public laws.[158]

On the other hand, concepts of political philosophy which deal with issues of the origin and the purpose of state support the political authority of state to make laws and enforce them over members of society.[159] In different periods of history, such political concepts which purport to serve the interests of all people and ensure the safety and security of a society have led to overturning of various social and economic regulatory laws. Although the arguments about the tension between the economic liberty and the legality of state interventions took different forms in a variety of historical contexts, every time when private rights of contract and property conflict with regulatory public policy, the former has given way to the latter.[160]

Furthermore, public law is, first and foremost, the realisation of social justice which is reflected in statutes and statutory rules passed by the state in the name of public interest. Precisely because the ultimate aim of public law in serving the public interest could be eroded, if

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[157] Mann wrote: "No one doubts that, except possibly in the case of infringement of fundamental human rights, the scope of a State's jurisdiction within its own territory and over its subjects is unlimited." F A Mann, 'Doctrine of Jurisdiction in International Law' (1964) 111 *Recueil des Cours* 1, 9.

[158] However, because of globalisation and the increase of transnational activities, traditional principles prescribing the limits of public law such territoriality and nationality have become insufficient. In increasing integrated global economy, there has been a need for some states to extend its legal authority to events beyond its normal boundaries. The US has been the obvious example of exercising of this extraterritorial jurisdiction. The US has applied its laws on competition, export controls, income tax and securities regulations to events outside its territory. For detail on this issue, see Mahmood Bagheri, *International Contracts and National Economic Regulation* (2000) Ch IV, Section 5.2 (Extraterritoriality: International Law in Crisis).

[159] The most important and influential theory justifying political authority is Social Contract Theory. In the sense of the social contract theory, government's decision on political and social matters is a product of an agreement among individuals since these individuals consent to the governmental authority. See generally P J Mccormick, *Social Contract and Political Obligation* (1987).

[160] Scheiber shows that any right including those implicating private property and which are at the core of classic liberal thought is subject to limits and increasing governmental regulation in any complex society. Even American society that cherished the axiom that 'private property ought to remain secure from the government' has supported the public interest notion. In constant tension between the individualistic property rights doctrine and public rights doctrine, the latter is given primacy. For more, see Scheiber, above n 50.

the public law is displaced, nations demarcate the boundary between those matters within the scope of private autonomy and those that are not. Thus, the normal prerogative of mandatory public laws under the classical system for settling contractual conflict of laws is that they apply regardless of the choice of law made in the contract.

In fact, by choosing the law of any state to govern the investment, the host state does not intend to completely renounce the application of its own law to the contract. Many aspects of the agreement which are immediately linked to the public law of the host state still continue to be governed by that law.[161]As regards economic development agreements, Maniruzzaman observed:

> "…issues arising out of such incidental matters as the protection of the environment, labour relations, taxation, foreign trade and exchange regulations are to be addressed by the law of the host State, even though that law may not be agreed by the parties to a contract as the applicable law. Such inevitable application of the law of the host States sounds paradoxical to the theory of internationalisation of State contracts which connotes the withdrawal of a contract completely from the impact of the host State."[162]

Nonetheless, in recent years American courts have extended the choice of law methodology to the field of public law authorizing the displacement of otherwise applicable US public law in a number of cases.[163] The phenomenon that has been now only accepted in the USA practice,[164] however is unlikely to be acted upon other jurisdictions because of some sharp

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[161] Philippe Kahn, 'Law Applicable to State Contracts: The Contribution of the World Bank Convention' (1968) 44 *Indiana Law Journal* 1, 12.

[162] A F M Maniruzzaman, 'International Development Law as Applicable Law to Economic Development Agreements: A Prognostic View' (2001) 20 *Wisconsin International Law Journal* 1, 31.

[163] In American law, the tendency to extend contractual autonomy to public law has arisen since the Supreme Court of the US first authorised the displacement of otherwise applicable US public law in a number of recent cases. See *Richards v Lloyd's of London*, 135 F 3d 1289 (9th Cir, 1998); *Lipcon v Underwriters at Lloyd's, London,* 148 F 3d 1285 (11th Cir, 1998); *Haynsworth v The Corporation,* 121 F 3d 956 (5th Cir, 1997); *Allen v Lloyd's of London*, 94 F 3d 923 (4th Cir, 1996); *Roby v Corporation of Lloyd's,* 996 F 2d 1353 (2d Cir, 1993); *Bonny v Society of Lloyd's***,** 3 F 3d 156 (7th Cir, 1993); *Riley v Kingsley Underwriting Agencies, Ltd,* 969 F 2d 953 (10th Cir, 1992).

[164] McConnaughay observed: "I am not aware of any nation other than United States that has declared with equal scope and clarity that claims arising under its public regulatory laws are either arbitrable or subject to displacement

differences between the common law and civil law traditions as well as differences in the political and social objectives of nations.

The continental European countries' commitment to social justice concerns has led to various interventionist social and economic programs. In these countries and other countries which pursue welfare objectives, the structure of law is based on the notions of "distributive justice". On the contrary in the US, conflicts theories reflect and promote the Aristotelian notion of "corrective justice". [165] Besides, the traditional legal divide between public and private is much clearer in civil law countries restricting the free choice of individuals only within the boundary of private law.

If the American model is accepted by different legal systems, it would cause alarming consequences. McConnaughay has revealed enormous risks that can be expected from the American model. The biggest consequence of such unconventional mythology is a risk of diminished regulation. In principle, parties to international transactions clearly would prefer public law that will substitute less burdensome regulation than the otherwise applicable public law. Consequently, one reasonably might expect the occurrence of the public harm that the displaced public law was intended to prevent.[166]

8.2.4. NON-ARBITRABILITY

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by contractual choice of law principles. Most nations, it seems, adhere to traditional assumptions that public law is neither arbitrable nor subject to contractual choice of law principles." See Philip McConnaughay, 'The Scope of Autonomy in International Contracts and its Relation to Economic Regulation and Development' (2000) 39 *Columbia Journal of Transnational Law* 595, n 73.

[165] William Tetley wrote that in the contemporary world, the difference between distributive and corrective justice is very evident in the principles underlying the social and legal systems of most industrialized democracies. In most of them (eg, the United Kingdom and Commonwealth countries, France, Germany), the legal and social systems tend to privilege distributive justice. On the other hand, in the social and legal systems of the United States, the rights of parties tend to be secured primarily through the pursuit of corrective justice. See William Tetley, 'A Canadian Looks at American Conflict of Law Theory and Practice, Especially in the Light of American Social and Legal Systems (Corrective vs Distributive Justice)' (1999) 38 *Columbia Journal of Transnational Law* 299-373.

[166] As McConnaughay observed, when forum public law is displaced, the result is that it will be replaced by lesser regulation or a regulatory void, perhaps increasing the risk of precisely the harm that forum public law was intended to prevent. McConnaughay, above n 164, 636-639.

The notions that keep public law out of the scope of conflict of law mythologies were accompanied by the development of the principle of inarbitrability of public law claims. The non-arbitrability concept is what the words mean the criterion to determine whether a particular dispute is subject to a private adjudication rather than being brought in state court. The primary justifications for such exclusion are paternalism and protection of third parties. The concept, then, is the recognition of the state's regulatory intervention in terms of considerations for the protection of public interest.[167]

The concept of arbitrability is generally agreed in various legal systems however, they use different methods and principles to identify arbitrable disputes and public bodies with capacity to arbitrate.[168] Nations either prohibit settlement of certain categories of disputes outside its courts or prohibit certain individuals and entities which are in most cases public authorities to enter to arbitration agreement. The former is known as "objective arbitrability", while the latter is termed "subjective arbitrability".

Nowadays, as it has been generally agreed most disputes concerning an economic interest that results from a financial legal relationship are arbitrable. Under objective arbitrability, however disputes arisen from some specific areas of law such as competition law, taxation law, bankruptcy law, family law, labour law, criminal law are never capable of

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[167] This public policy requirement is universally accepted. See *Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, opened for signature 10 June 1958 and entered into force 7 June 1959 330 UNTS 38 (hereinafter *New York Convention*). Art 5 (2) states:

> Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that:
>
> (a) The subject matter of the difference is not capable of settlement by arbitration under the law of that country; or
>
> (b) The recognition or enforcement of the award would be contrary to the public policy of that country.

[168] When the statutory provisions of different countries conflict with each other, the issue whether a particular person can submit his dispute to arbitration is settled under that person's personal law, whereas the issue whether a dispute is arbitrable is governed by the law of forum. For the choice of law methods in this area see Gaillard and Savage, above n 20, 316-318.

settlement by arbitration.[169] Subjective arbitrability checks the capacity of the contractual part to enter into an arbitration agreement. Under most domestic jurisdictions, states, local authorities and other public entities are typically incapable of submitting their disputes to arbitration.[170] This is because public entities normally exercise a sovereign function that would be submitted to the jurisdiction of public courts but not private justice.

However, it must be acknowledged that the issue of arbitrability is decided quite differently in case of international contracts. What is different is that the domestic law prohibitions to submit some disputes to arbitration have long been inapplicable to contracts which are international in nature. The principle was first established by the Paris Court of Appeals' decision in the 1957 *Myrtoon Steamship Case*.[171] Then, the position of French law has been followed in some other jurisdictions.[172] This is the case especially in America, where the American Courts held in ongoing series of cases that both contractual and statutory claims are generally arbitrable.[173] The justification for the rulings was to promote predictability in

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[169] Art 2060 of the *French Code of Civil Procedure* provides: "disputes concerning public collectives and public establishments" cannot be referred to arbitration. However, some countries already have authorised the arbitration of public law claims in the international context. For American cases see n 173.

[170] Art 1676 of *Belgian Judicial Code* states that, "anyone, except public entities, with the power to enter into a settlement, may enter into an arbitration agreement." Other countries also have similar prohibitions. For prohibitions in Islamic legal systems, see Abdul El-Ahdab, *Arbitration with the Arab Countries* (2nd ed, 1999). Eg, in Saudi Arabia, the law prohibits any government agency to be party to arbitration, national or international: at 575.

[171] *Myrtoon Steam Ship v Agent Judiciaire du Tresor*, Corte de Apelação, Decision of 10 April 1957.

[172] There has been no an evidence found how many countries accept the rule. Countries such as Greece, England, Italy and Tunis adopted the principle. See Gaillard and Savage, above n 20, 323.

[173] The trend of American law emerged with the decision of the Supreme Court in *Bremen v Zapata Offshore Co,* where the court held that the choice of forum clause was an "indispensable element of international trade" and that where it was included "in an arm's length negotiation by experienced businessmen, it should be honoured by the parties and enforced by the courts". See *Bremen v Zapata Offshore Co,* 407 US 1 (1972). Then in *Scherk v Alberto-Culver,* the US Supreme Court authorised the international arbitration of claims arising under the Securities Exchange Act of 1934, in *Mitsubishi v Soler Chrysler-Plymouth* the Court authorised the international arbitration of claims Sherman Act. See respective cases *Scherk v Alberto-Culver Co,* 417 U S 506 (1974); *Mitsubishi v Soler Chrysler-Plymouth,* 473 U S 614 (1985).

international trade. Also in the *Ken-Ren* decision,[174] the English High Court departed from previous position not to order security for costs in an international arbitration.[175]

The differences in attitudes of both laws towards the issue of arbitrability can be understood by the very nature of international law and that of municipal law. The primary objective of international commercial law is to contribute enormously to the efficiency of international commercial transactions. The liberal tradition of international economic relations either prevents parties to international contracts from being subject to multiple simultaneous lawsuits in several different jurisdictions or enables commercial parties to reliably select an applicable law and arbitral forum. National legal systems, on the other hand tend to restrict arbitrability to ensure the protection of the public interest which represents distributional and welfare values of a society.

Even though arbitration derives from mutual consent of the parties, as far as state parties to contracts are concerned, the issues of capacity and authority are very important for determining the validity of the consent. Generally, the capacity of each party to enter into an arbitration agreement is established according to his national law.[176] Especially, public administration organs must have authority to arbitrate under its national law. A problem of the invalidity of the agreement may arise in the absence of such authority of the signatory.[177] On the

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[174] *SA Coppee Lavalin NV v Ken-Ren Chemicals and Fertilisers Ltd* [1994] 2 All ER 449.

[175] The *Ken-Ren* decision resulted in amendments to the Arbitration Act, s38 of which now gives arbitral tribunals authority to order security for costs, even in the absence of prior agreement between the parties. See *UK Arbitration Act* (1996).

[176] The view that every award must be based in some domestic legal system and the issue of arbitrability has to be decided according to the domestic law still gains broad credence. Mann asserted that every activity occurring on the territory of a State is necessarily subject to its jurisdiction even if the participants desire to remove themselves from its control. He observed that some States may give the parties more leeway in this regard, but no State has ever totally abdicated its control over what takes place in its geographic territory. As he stated, he municipal law of the seat of the arbitration must be the law governing the arbitral award and the parties can only enjoy freedoms granted by the country of the seat [of the arbitration]. See F A Mann, "'Lex Facit Arbitrum'," in Pieter Sanders (ed), *International Arbitration Liber Amicorum for Martin Domke* (1967) 157, 160-161.

[177] However, it should be noted that the issue whether arbitration clauses are invalid because they are concluded in contravention of laws denying capacity to arbitrate to a state or its agency has not been fully settled. Many supporters of internationalization of state contracts argue that the international arbitrators are not bound by these

other hand, the defence of non-arbitrability can be effectively invoked in cases where a foreign sovereign's formal acts are concerned. In *Liamco,* the US district court refused to enforce the award against Libya on the grounds that Libya's nationalisation, being an act of state, is a subject matter not capable of settlement by arbitration.[178]

8.2.5. STATUTORY POWERS

In most domestic legal systems it is well recognised that a state or a state agency cannot fetter the exercise of a statutory power by committing itself by contract. The concept, which is sometimes referred to as the doctrine of executive necessity, involves the idea that contracts or other agreements and promises are unenforceable in the public interest if they fetter or purport to fetter statutory executive discretions and powers. The rationale is that in the public interest, government is required to act at times to override existing private rights including those rights emanating from contract. Mason CJ noted in *Attorney-General (NSW) v Quin* that:

> "… I am unable to perceive how a representation made or an impression created by the Executive can preclude the Crown or the Executive from adopting a new policy, or acting in accordance with such a policy, in relation to the appointment of magistrates, so long as the new policy is one that falls within the ambit of the relevant duty or discretion, as in this case the new policy unquestionably does. The Executive cannot by representation or promise disable itself from, or hinder itself in, performing a statutory duty or exercising a statutory discretion to be performed or exercised in the public interest, by binding itself not to perform the duty or exercise the discretion in a particular way in advance of the actual performance of the duty or exercise of the power." [179]

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national law restrictions. See for example, Pierre Lalive, 'Transnational (or truly International) Public Policy and International Arbitration' in Peter Sanders (ed), *Comparative Arbitration Practice and Public Policy in Arbitration* (1987) 297.

[178] The court reasoned that:

"Had this question been brought before this court initially, the court could not have ordered the parties to submit to arbitration because in so doing it would have been compelled to rule on the validity of the Libyan nationalisation law.... [and therefore violate] the act of state doctrine." *Libyan American Oil Co ("LIAMCO") v Socialist Peoples Libyan Arab Jamahirya*, 482 F Supp 1175 (DDC 1980), at 1178-79.

[179] See *Attorney-General (NSW) v Quin* (1990) 170 CLR 1, 17-18.

However, as far as foreign investment contracts are concerned, this concept of executive necessity has been phased out by international investment arbitrations as it could enable the sovereign to alter foreign investment contracts through its legislation. Instead, the investment arbitrations have formulated a monist notion that a state party should be not permitted to plead its own law in order to escape from an obligation. A clear formulation of this view is to be found in the opinion of Lauterpacht J in the *Norwegian Loans* case in the following terms:

> "It is not enough for a state to bring a matter under the protective umbrella of its legislation, possibly of a predatory character, in order to shelter it effectively from any control by international law."[180]

In a further effort to control the municipal law, one technique has been to develop so-called stabilisation clause by which the host state guarantees not to alter the contractual rights of foreign investors during some specified term of years.[181] Stabilisation clauses were introduced in 1950s and 1960s contracting practice. However, after so any years there still remains a great controversy whether a government or a statutory authority has the power to commit itself by contract or otherwise to the future exercise in a particular manner of a statutory discretion or statutory duty.

From a doctrinal point of a view, such clauses are unenforceable because an attempt to fetter the public powers of the state would constitute derogation from the principle of sovereignty.[182] On the other hand, concepts such as the doctrine of permanent sovereignty over natural resources[183] have seriously eroded the continuity of the practice of "freezing the

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[180] *Certain Norwegian Loans (France v Norway)* [1957] ICJ Rep 9, 37.

[181] The stabilisation clauses are also discussed in Chapter Three, Subsection 3.2.3(Inclusion of Contract Clauses).

[182] Angelo Sereni, 'International Economic Institutions and the Municipal Law of States' (1959) 96 (1) *Recueil des Cours* 129, 210; Muthucumaraswamy Sornarajah, *The Pursuit of Nationalized Property* (1986) 2-51.

[183] See the discussions on the principle of permanent sovereignty over natural resources in Ch Six, Subsection 6.1.2 (Doctrine of Permanent Sovereignty over Natural Resources) and Subsection 6.2.1 (The Legal Status of the New Principles: Are they Custom?).

law of the host state". The doctrine asserts exclusive national control over the foreign investment process.

In international arbitration practice, no a uniform and clear approach to the stabilisation clauses has emerged so far, despite the efforts of international arbitral tribunals to give recognition and validity to stabilisation clauses under international law. One commentator who researched the arbitral awards involving the issue of stabilisation clauses noted that in two of three cases the arbitrators came to the conclusion that the stabilisation clauses cannot prevent a unilateral change of terms and conditions by the government.[184] Thus, uncertainty as to the precise status of these clauses exists not only in scholarly writings but also in arbitral practice.

Making matters even worse, recent arbitral awards have accepted the governments' exercise of regulatory power to frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may make certain activities less profitable or even uneconomic to continue.[185] In that context, several arbitral decisions confirm the relevance of the police powers doctrine to the investment contracts.[186]

The *Feldman Award,* for example, recognised a line separating a valid regulation from a compensable taking.[187] On this ground, it came to the following conclusion:

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[184] Thomas Waelde and George N'Di, 'Stabilising International Investment Commitments: International Law versus Contract Interpretation' (1996) 31 *Texas International Law Journal* 215, 246.

[185] *Marvin Roy Feldman Karpa v United Mexican States* (Award) (16 December 2002), 42 ILM 625 (2003), para 112.

[186] The *Saluka* Tribunal interpreted the BIT taking into account relevant rules of general customary law, and under its light concluded:

"In the opinion of the Tribunal, the principle that a State does not commit an expropriation and is thus not liable to pay compensation to a dispossessed alien investor when it adopts general regulations that are "commonly accepted as within the police power of States" forms part of customary international law today. *Saluka Investments BV v The Czech Republic*, Partial Award, 17 March 2006, UNCITRAL Arbitration, paras 254 and 262. Also see *Methanex Corporation v United States of America* (Final Award) (3 August 2005), 44 ILM 1345 (2005), para 7.

[187] *Marvin Roy Feldman Karpa v United Mexican States* (Award) (16 December 2002), 42 ILM 625 (2003), para 100.

> "The Tribunal notes that the ways in which governmental authorities may force a company out of business, or significantly reduce the economic benefits of its business, are many. In the past, confiscatory taxation, denial of access to infrastructure or necessary raw materials, imposition of unreasonable regulatory regimes, among others, have been considered to be expropriatory actions. At the same time, governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognises this […].[188]

Seemingly, the decisions of arbitral tribunals indicate that international arbitral tribunals begun to take into account the necessity of statuary powers of the host to modify the regulatory environment of the foreign investment projects for the public good. Indeed, one cannot deny the host state's statutory power to make legislative changes in tune its social and economic policies. State contracts by virtue of their public interest component "cannot be insulated from the pressures which impinge on public institutions such as political changes in the country, changed economic conditions and general expectations of the public."[189] The expression of free will and the binding effect of contractual obligations in state contract are thus not the same as in ordinary contracts between private parties.

8.2.6. ULTRA VIRES

Technically, a state or its agency cannot be totally libertarian in entering into contractual arrangements. In most jurisdictions, government officials have to be explicitly empowered with regard to the nature, scope and procedure of contracts. For example, the rules of capacity of a state entity, the types of areas in which the state entity has the capacity to conclude are stated in

[188] Ibid, para 103.
[189] See Samuel Asante, "Stability of Contractual Relations in the Transnational Investment Process" (1979) 28 *International and Comparative Law Quarterly* 401, 404.

statutes and regulations. The contracting powers of government authorities thus, are restricted within such statutes.

In that context, a state agency is permitted to conclude contract only in cases where the legislature authorises to do so. In *Cudgen Rutile (No 2) Pty Ltd v Chalk*,[190] the Privy Council determined that whenever a statute prescribes a mode of exercise of the statutory power, that mode must be followed and observed. Their Lordships cited with approval the following observation of Rich J in *New South Wales v Bardolph*[191]*:*

> "When the administration of particular functions of government is regulated by statute and the regulation expressly or impliedly touches the power of contracting, all statutory conditions must be observed, and the power no doubt is no wider than the statute contemplates."

In domestic legal systems hence, it is well established that if government contracts are concluded by government authorities with insufficient authority or not all necessary steps were taken, these contracts are regarded as *ultra vires* and therefore void.[192] The doctrine applies to foreign investors too. A private party domestic or foreign alike, thus, to prevent a contract from being voided as *ultra vires*, must be aware of the contractual capacity of a government employee with which he deals.[193]

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[190] *Cudgen Rutile (No 2) Pty Ltd v Chalk* [1975] AC 520; (1974) ALJR 22.

[191] *New South Wales v Bardolph* [1934] 52 CLR 455, 496.

[192] In Wool Tops case, the Australian Government entered into a contract with a company providing either for the giving of consent to the sale of wool tops by the company in return for a share in the profit thereby arising or alternatively that the Commonwealth should pay the company an annual sum in respect of the manufacture of the wool tops, or a combination of both. Knox C J and Gavan Duffy J held that the agreements were in any event invalid because they were neither authorised by the Constitution nor by statute. *Commonwealth v Colonial Combing Spinning and Waving Co Ltd* (1922) 31 CLR 421.

[193] See *Morgan Guaranty Trust Co v Republic of Palau* (1987) 657 F Supp. 1475. The case concerned a state contract made by the Republic of Palau. In Palau, there were constitutional limitations preventing state officials to bind the state in contract and the court stated that a foreign party seeking to enter into a contract with the state should be credited with the awareness of these limitations.

In arbitral jurisprudence, however, the view of *ultra vires* has become obsolete.[194] International arbitral tribunals have formulated various defence principles to prevent the application of the *ultra vires* doctrine. In the *Sapphire Award*, for example Judge Gavin dismissed the arguments of contractual incapacity based on the host state's laws with the extraordinary observation that a foreign corporation cannot be expected to know the host state's laws.[195] In another case, *Company Z v State Organisation ABC,* the contract was signed by an officer who had no approval. The *ad hoc* tribunal recognised that there was a duty on the part of the foreign corporation to acquaint itself and abide by local procedures and laws, however, it did not characterise the contract as invalid. Instead of applying the doctrine of *ultra vires*, the *ad hoc* tribunal was of the opinion that in view of the state corporation's "habitual practice" of violation of law, the foreign contractor should not be blamed for its violation of law.[196]

Furthermore, the doctrine of estoppel has been frequently used to prevent the defence of *ultra vires* once the transaction has been started,[197] and to prevent changes being made to the legal regime in reliance of which the foreign investor entered.[198] But the application of the principle of estoppel in the field of investment disputes is suspicious partly because of the lack of evidence showing the principle as a general principle[199] and partly because generally the principle

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[194] *Tinoco Arbitration* which was held before the development of the theory of internationalisation supported the proposition that if the investment agreement was *ultra vires* under the host state's law, then the agreement was void. See *Tinoco Arbitration (Great Britain v Costa Rica)* (1923) 1 RIAA 371.

[195] *Sapphire Award* 35 ILR 136 (1963). In domestic legal systems it is well recognised that an ignorance of the law excuses no man.

[196] *Company Z v State Organisation ABC* (1983) 8 VCA 94, 102. The sentence in the report reads as follows:

"If, according to its own declarations before the arbitral tribunal, ABC itself, was not able to resist 'an habitual practice' of violation of the law, it is evident that the foreign contractor could not do so either".

[197] Used in *Company Z v State Organisation ABC* (1983) 8 VCA 94.

[198] Used in *Marvin Roy Feldman Karpa v United Mexican States* (Award) (16 December 2002), 42 ILM 625 (2003), paras 59-65.

[199] Sornarajah asserts that the status of the doctrine of estoppel as general principles is unclear. See Sornarajah, above n 182, 113-117; 209-212.

of estoppel is used in contract law to prevent contractual parties from relying upon a set of facts which is different from an earlier set of facts.[200]

However, one must admit that an attempt to borrow some peculiar principles from the area of private law and apply them to disputes involving the public interest should be made with caution. The same legal effect that attaches to the conduct of private parties in purely commercial transactions, which they are presumed to have considered with the utmost seriousness, cannot apply in transactions of a complex nature such as one on the exploitation of natural resources where important political and public interests are involved. It is undeniable that a state party may be able to bring about interruption of contracts under exceptional circumstances when the public interest aspects require it to act so.

8.3. Summary of Findings

The discussions in this chapter establish that though party autonomy was formally recognised by the *ICSID Convention* a few decades ago as the primary choice of law method of settling disputes between a state and foreign private party, in reality, it hardly applies. First of all, ICSID arbitral tribunals have developed radically different approaches towards party autonomy. What used to be the practice in the free marketplace in which the parties choice is treated with ultimate respect and enforced unless it would vary mandatory rules of relevant legal systems, is no longer, in general, the case. The doctrine of supplemental and corrective function of international law developed by ICSID does not necessarily let the enforcement of the contractual choice of law because such chosen law may be subject to correction by arbitral tribunal in case of

[200] Common law systems have been reluctant to apply the doctrine of estoppel by conduct to the state or state entities. As Gummow J observed in *Minister for Immigration v Kurtovic* (1990) 92 ALR 93, 111:

"in a case of a discretion, there is a duty under the statute to exercise a free and unhindered discretion and an estoppel cannot be raised (any more than a contract might be relied upon) to prevent or hinder the exercise of the discretion; the point is that the legislature intends the discretion to be exercised on the basis of a proper understanding of what is required by the statute, and that the repository of the discretion is not to be held to a decision which mistakes or forecloses that understanding." Also see *Attorney General for Ceylon v Silva* (1953) AC 461; *Smith v Attorney-General* [1973] 2 NZLR 393; *Meates v Attorney- General* [1979] 1 NZLR 415; *Society of Medical Officers of Health v Hope* [1960] AC 551.

inconsistency with international law. This may be demonstrated by two arbitrations: (a) the arbitration between Liberian Eastern Timber Corporation and Government of the Republic of Liberia and (b) the arbitration between Southern Pacific Properties Limited and Arab Republic of Egypt.

However, some recent cases decided by ICSID tribunals show the emergence of a new model which is more practical than the aforementioned one. Rather than an attempt to apply international law in every circumstance declining the application of relevant domestic law, ICSID arbitration is applying both systems of law to respective issues by identifying the subject matter of dispute before it. The new approach, ie the issue-specific approach to conflict of law in the context of state contracts is generally consistent with conventional rules of private international law.

On the other hand, it appears that because of the involvement of a state in the contractual disputes, various issues related to sovereignty could arise. For example, principles like the act of state doctrine, sovereign immunity and executive necessity, which never feature in ordinary contractual relationships between private parties, impede the adoption of party autonomy in situations where a state or a state agency is party to a contract with a foreign private party. Although these principles rest upon different grounds and their status and scope are different, they would produce the same result, which is not to allow the full vindication of private rights and a free choice of an applicable law in foreign investment contracts in which the state or its agency is a party. Thus, even though parties to a state contract when drafting their contract can choose any law as the law governing the contract, but they must expect that in the real world such a choice of law is very unlikely enforced.

Furthermore, it must be admitted that conventional rules of conflict of law which are applicable to private law disputes are not capable of dealing with disputes arising from public

law issues primarily due to the territorial sense of public laws. The application of public law rules is always, explicitly or implicitly limited in their jurisdictions. It is not possible to enforce public law rules outside the territory of the enacting country. Accordingly, if one has to resolve conflict of public law rules, principles of jurisdiction such as nationality and territoriality could be better solutions rather than the conflict of law rules.

It is also noteworthy that the theories that are discussed in the final section are not the only causes of the limited application of party autonomy in state contracts. Rather, this situation may be caused from the existing practice. In reality, in most foreign investment contracts, the law of the host state is chosen by the parties as the proper law[201] and the references to the law of the investor's home state or to the law of a third state are rare.[202] Meantime, legislative compliance will be greater in field of natural resources, as the area came to be perceived as of vital importance to the development of national economy and the wellbeing of its people. In many countries, laws concerning the exploitation of natural resources, foreign investments, technology transfers have been enacted clearly demonstrating obligations of the parties involved in the activities. This leaves party autonomy little room making the contractual solution to conflict of law in state contracts illusory and redundant.

[201] Maniruzzaman, above n 96, 309. Also Delaume noted that in the late 1980s there has emerged a trend to depart from "internationalization" devices used in earlier decades and to "re-localize" the relationship under the law of the host state. Georges Delaume, *Law and Practice of Transnational Contracts* (1988)15.

[202] Schreuer, above n 17, 561.

Part Six: CONCLUSIONS AND RECOMENDATIONS

A. SUMMARY OF THE THESIS

This thesis has attempted to show that, although the methodology for the resolution of conflict of laws in disputes between a host state and a foreign investor was adopted by the ICSID Convention more than a half century ago, in actual reality the issue of choice of law in foreign investment contracts has never been satisfactorily settled. Making the situation even worse, new developments within the field of international investment law require reconsideration of the questions on the applicable law of foreign investment contracts once again. Especially, the contractual freedom to choose the applicable law has become increasingly unsuitable for resolution of conflict of laws in investor /state contractual arrangements in light of a growing regulatory sphere. The same old problems caused by the expansion of this truly private law principle beyond individuals' domain to regulatory matters are re-emerging.

Prior to the presentation of the summary and conclusions, it is initially appropriate to re-state the research problem as previously presented in the *Introduction* to this thesis.

- *Is the party autonomy rule, which naturally deals with purely private law conflicts, also capable of being applied to disputes between a state and a national of another state and what is the outcome of applying party autonomy to disputes involving public interests?*
- *How far may a government party to an economic development agreement choose the law of other country which has no relevance to its economic and developmental policies?*

The thesis summary is sub-divided in accordance with the preceding eight chapters of this thesis. Answers regarding the above research problem will be extracted from the discussion and highlighted.

First and foremost, as it is shown in *Chapter One*, the roots of state/private party business co-operation can be traced to the late 19th century, when an increasingly complex

society forced upon government a multitude of administrative and managerial functions aimed to deliver a wide range of services to the public. The basic principle of this co-operation is that the state, ie the administration contracts on behalf of the society, for the necessities of the public service, for the common general interest. More advanced domestic legal systems thus have developed the concept of public law contract eg, *"contrat administratif"* the purpose of which is to maintain a contractual balance between the public interests of administration and the individual interests of a private contractor. While conferring special treatment upon the state party, the doctrine also protects the private party from any unilateral change of the contractual terms by the administration by granting the right to an indemnity. In domestic systems, where the concept of public law contract is unknown, it is still well-accepted that the power of the administration entered into a contract is not dependent on the contractual terms; rather its prime duty is to act in the interests of the public. In all domestic legal systems therefore it is assumed that every action that a government takes is purported to implement public's goals and values embedded in national laws. For a government, thus the freedom to select a foreign state's law as the governing law of its actions does not exist. Would it be seen as a betrayal of public trust if a government commits itself to rules of a foreign law?

Chapter Two reviews the past and current international response to the issue of state contracts in the practice of international arbitration. In spite of the developments in municipal legal systems, the attitude of international investment arbitral tribunals so far does not differ in the case of foreign investment contracts from the case of mere commercial contracts. Although the theory of internationalisation of state contracts created by early arbitral jurisprudence as well as the writings by advocates for the theory required concession contracts to subject to rules of public international law, corresponding reflections were few and far between in the realm of public law. Obsessed with attempts to protect private interests of foreign investors against

interventions by a host state, earlier international arbitral tribunals pushed commercial law principles too far while phasing out established practices in domestic legal systems with regard to the issues of government contracting. However, the attitudes of international arbitral tribunals are changing. Certain trends now have been discerned in the case law that point to the need for a host country to regulate its economic activities including the matters of foreign investment in the national policy interest. Of the central importance of such trend is the recognition of the public or regulatory side of foreign investment contracts. In the light of the increasing public law considerations, party autonomy, and indeed any other choice of law rule would become less relevant in the context foreign investment contracts.

Chapter Three examines the historical and theoretical foundations of theory of internationalisation of state contracts. The idea to subject foreign investment contracts to public international law emerged as a reaction to the waves of nationalisations of foreign owned properties carried out in newly independent states. Both party autonomy and arbitration served as an "escape device" in the interest of foreign investors enabling foreign investors to insulate foreign investment contracts from the orbit of the host state's domestic legal system and the jurisdiction of its courts. Much controversy and confusion about the theory arose from the fact that there were no rules of public international law which directly regulate investor/state contractual relationships except for some general rules on state responsibility. Advocates for the theory of internationalisation thus utilised *lex mercatoria* or general principles of law as primary sources of international law. Yet, *lex mercatoria* or general principles of law are purely commercial principles which were originally created by international merchants to serve their needs. The rules are designed to fulfill private objectives, but not national social or economic objectives. In this sense, one should not apply private law principles alone in the case of state contracts. Otherwise, the public interest will suffer. Is a state no different from a mere trader?

Chapter Four comprises a critical examination of the internationalisation theory. A key point in this chapter is that the theory of internationalisation did not solve choice of law problems in state contracts. Rather it has introduced new controversies. In particular, the early arbitral tribunals of oil cases took a view that a state contract will always be subject to international law despite any municipal law being chosen by the contracting parties as the sole proper law of the contract. Such assumption was somehow bizarre to the traditional function of party autonomy. Under conventional rules of private international law, nothing except for some mandatory rules of law can override the contractual choice of law. Yet, in the earlier arbitration cases, parties' chosen law was replaced with general principles of law which have no a mandatory character. The application of international law by earlier arbitrators contrary to the choice of law clauses in concession contracts suggests that it is possible that the advocates for the theory of internationalisation meant to adopt mandatory choice of law rules not party autonomy.

Chapter Five has demonstrated that the current rules of international investment law are biased towards TNCs. Since the immediate post-colonial period, capital exporting states have sought to establish new rules protecting foreign investors. Most of these rules such as rights of admission and establishment, national and most favoured nation treatment, full compensation in the event of expropriation, rights of repatriation of profits and arbitration by the foreign investor in the event of disputes with the host states are embedded in various bilateral and regional treaties which now became a main source of international law on foreign investment. In light of these extensive private property-focused provisions of investment treaties, host state's economic development issues have been ignored. What is worse is that the treaties with exclusive objective of investment protection have disabled host states from taking certain measures to protect public values. The NAFTA experiences, which have led the US and

Canadian governments to pay billions of dollars to corporations for taking public policy measures, are making developed governments understand how far they have gone with investment protection. As a result, it is possible that developed states might lower the standards of investment protection. The absence of investor-state dispute settlement provisions in *Australia-US FTA (AUSFTA)* is a clear illustration of this possibility. It could mean that the same thing might happen to the provisions giving parties the freedom to choose the applicable law and one day they may be replaced with a mandatory choice of law rule.

Chapter Six outlines the competing concepts of foreign investment stressing the right of people to development, environmental concern and human rights promotion. The notions that long have been advocated by developing states and global civil society organisations finally begun to have implications in treaty negotiations and arbitration practices. Recent investment treaties have put a greater emphasis on environmental concerns by exempting a host government's measures related to the environment protection from the scope of treaty regulation. ICSID case law also has developed a test according to which only foreign investment that does contribute to the economic development of a host state is entitled to standards of protection. All these could mean gradual erosion of foreign investors' extensive rights and privileges. Of these rights, the freedom to choose the governing law of the contract should be curtailed first. When investment protection was primary goal of the international law on foreign investment, the principle of party autonomy produced the desired effect effectively eliminating the application of the law of a host state which seemed to be disadvantageous to foreign investors. But now there is occurring a shift from international law emphasizing the protection of investment to international law stressing the rights of people to develop. Thus, the party autonomy rule has to be modified reflecting the shift. Otherwise, rules of a host stet's law specifically designed to ensure economic growth and

development could be avoided by parties' choice of law clause. Then, there will be less growth and less development or even could be nothing.

In *Chapter Seven* the traditional functions of the party autonomy rule are assessed. It is submitted that the party autonomy principle is not without limits even in pure private law relationships. Like any other private rights, contractual freedom can be curtailed if, found to be incompatible with some regulatory norms. Due to the increasing concern of modern municipal private law systems on social justice, courts started to intrude upon private contractual relations more than ever before. One example is the concept 'constitutionalization of private law'. The notion entails that contract law is not an autonomous sphere for private actions, but an object of constitutional justice. The aim of the constitutionalization of private law is to make contract law society-oriented, so that contractual promises are enforced as long as they are not in conflict with society's goals. The concept has broader application than traditional barriers to freedom such as mandatory rules and public policy exceptions. Accordingly, if the concept is accepted in the context of international law, the contractual freedom to choose the governing law in contracts in which a state is party is likely to be abolished. However, that might not happen in the near future, because national legal systems and international law have generated distinct notions of party autonomy. In contrast to national laws, international law magnifies the ideas of freedom of contract and private autonomy but is not committed to social justice.

The last chapter of this thesis, *Chapter Eight* has investigated the extent to which parties to foreign investment contracts, ie the host state and a foreign investor are free to choose the law applicable to their contract. In first instance, it is revealed that, under the internationalisation theory, international arbitral tribunals have interfered with the parties' choice of municipal law on the ground of the so-called doctrine of supplementary and corrective function of international law. In the view of investment arbitral panels, the parties' choice has to be tested against

applicable international rules. If it passes the test it would apply. Otherwise, the parties' chosen law is dismissed. In recent years, however a new trend has emerged separating claims arising from a same dispute into to categories: contract claims and treaty claims. Depending on the particular circumstances of the case, an arbitral tribunal applies either international law (in the case of treaty claims) or the host state's law (in the case of a contractual claim). The development of this approach could mean in general the applicable law of foreign investment contracts is the law of the host state along its treaty rules. The new approach thus reduces the applicability of party autonomy in foreign investment contracts.

Chapter Eight also discusses the possible restrictions that can be placed on the right of parties to state contracts to freely choose the governing law of the contract. It is one thing adopting the principle of party autonomy as the main choice of law rule but it is another thing exercising it in a real life and taking advantage of it. No matter how one chooses a legal system favorable to it, it always has to face numerous hurdles in the form of legal theories, substantive and procedural laws. This is particularly true when the case involves actions taken by, or at the direction of a foreign government which has sovereignty related privileges. In modern international law, immunity is pleaded only for acts performed in the exercise of sovereign power but withdrawn in respect of acts of a commercial or private law nature. With the trend towards the public law nature of foreign investment contracts, the issue on sovereign immunity could revive in state contracts at the stage of execution, especially with respect to attachment and execution on assets of a foreign sovereign. Even in cases where the enforcement of contractual choice of law can overcome the sovereign immunity hurdle, it may face other hurdles such the Act of State doctrine and the doctrine of executive necessity. As the Act of State doctrine enforces a public act of the foreign sovereign, the choice of law agreement of parties can be invalidated by such act. Under the doctrine of executive necessity or police powers doctrine, any

state enjoys administrative powers to conduct normal functioning of the state machinery. When the government concludes a foreign investment contract which is essential for its economic development, it is not driven by its own will, but by that of legislators. It acts an agent of its people only operating within the powers given to it by the constitution and other laws. No government officer has authority to deviate from the procedures and regulations, set forth by the laws.

B. CONTRIBUTIONS OF THE THESIS

The major contributions of the thesis can be summarised as follows:

- It has identified the fundamental characteristics of investor/state contractual relationship revealing that foreign investment contracts have their roots in the concept of public law contracts. In principle, a public law contract is a vehicle of realisation of society's goals, and therefore it should be subject to the law of the state party but not to party autonomy. One of the main defects in the theory of internationalisation of state contracts has been the ignorance of the public law features of foreign investment contracts. A few international scholars (Sornarajah and Mannruzaman) have made concerns and comments about how the important public law features of the contracts have been disregarded by international arbitral tribunals. But there is no literature specifically dealing the issues how the private law approach to the nature of foreign investment contracts could affect the development of choice of law method and what consequences of applying such a method to the resolution of foreign investment disputes.
- It has reviewed the choice of law issue in foreign investment contracts from historical, theoretical and empirical perspectives demonstrating that the issue which was first introduced by the theory of internationalisation of states contracts so far remains complicated. It is assumed that one of the foundations of internationalising the applicable law is the principle of party autonomy. Contrary to the belief, the thesis shows how the principle of party autonomy has never been applied correctly in the international arbitration jurisprudence. In the light of the corrective and supplemental functions of international law, the chosen law is subject to the correction and supplementation by international law.
- It has explored the legal sources of international investment law considering them in the context emerging principles on economic development law. The inclusion of environmental, social and developmental aspects within the international law on foreign investment is about to change the way of establishing, applying and interpreting a rule of international law. In other words, the

international law on foreign investment is no longer the law which is only concerned with the investment protection, but rather its focus on environmental and developmental policy considerations is increasing. The thesis argues that the party autonomy rule has been seen to be unsuitable because the host state's law enacting the developmental policy objectives could be excluded by the contractual selection of the governing law.

- It has proposed for the first time changes to the ICSID rules on the choice of law. Acceptance of the principle of party autonomy by the ICSID was based on the theory of internationalisation of state contracts which itself was created as a panic response to mass nationailsations of foreign-owned properties by the newly independent states. It offered a "quick fix" for the choice of law problems in early oil disputes, but could not resolve root problems. The applicable law of foreign investment contracts was internationalised because national law was found inadequate from the point of view of investment protection. In recent years, the role of national law of a host state has assumed greater importance than ever before due to new concerns of international foreign investment law: social, developmental and environmental aspects of foreign investment. This thesis argues that the area of foreign investment deserves a more serious approach to the choice of law question.

C. RECOMMENDATIONS OF THE RESEARCH

On the basis of the analysis of issues discussed in this research, the general recommendations are in order for policy makers, international law scholars and national or international organisations involved with this matter in the hope of taking positive steps towards developing more balanced and effective international legal system on foreign investment. The recommendations are as follows:

1. Immediate attention needs to be given to the importance and seriousness of reconsideration of the choice of law issues in foreign investment contracts. National policy makers, international forums, scholars and human rights and environmental advocates concerned with the regulation of the foreign investment should be talking about the unsuitability of conventional conflict of law rules such as party autonomy in foreign investment contracts.
2. A Multilateral Foreign Investment Treaty needs to be drafted and negotiated. It will be impossible to control or direct foreign investment through domestic law alone. Public international law thus should be involved to provide general standards by which to judge actions of participants of foreign investment activities. Today, there are two tendencies on the regulation of foreign investment: investment protection and economic development. Those

engaged in the formulation of rules and regulations on the international investment should reconcile these two differing objectives. The UNCTAD will be a more appropriate venue for multilateral investment negotiations than the international financial institutions like the WTO and IMF which are almost exclusively concerned with the corporate commercial interests. For decades the UNCTAD has been the voice of developing countries, so it can give the negotiations a development perspective.

3. A new conflict of laws approach needs to be developed. Like every individual has own private interests, every state has its own national political and economic interests. Economic regulations and policies are a means of advancing such national security and economic interests. One area which has been the focus of economic regulation of any country is foreign investment. Most disputes between a host state and a foreign investor therefore arise over the conflicts between a contract and economic regulation. The traditional approaches to the conflict of laws are highly unsuitable because they are designed to protect private rights but not the public interest. The new approach should not be based on the traditional conflict-of law rules alone, rather should be capable of promoting development by focusing on state interests embedded in economic regulations. There are areas where conventional choice of law rules have been modified and replaced by more workable approaches.
4. Changes must be made to the text of the ICSID Convention. In order to give guidance for the difficult task of modifying the choice of law approach, this thesis proposes two versions of the wording for Article 42 (1).
    - Version One: "The Tribunal shall decide a dispute in accordance with the law of the Contracting State party to the dispute and its treaty rules. Other international rules that are not ratified by the host state are applicable to the extent they have a mandatory character".
    - Version Two: "The tribunal will decide a dispute in accordance with parties' chosen law. The following contracts which are naturally presumed to be important to the economic development of the host state are subject to the law of the host state despite the existence of choice of law clause opting for some other foreign law:
        - All contracts in the natural resources sector regardless of the form and type of the contract such as concession contracts, joint venture contracts, production-sharing contracts;
        - Contracts in the public utilities sector, such as roads, telecommunication, water and energy;
        - Contracts for the purchase by a foreign party of the equity of in a state enterprise.

D. CONCLUDING REMARKS

The outcome of any dispute such as disputes arising out from foreign investment contracts between a host state and a foreign investor depends on rules governing such a dispute. If the governing law is market-oriented and concerned with individual rights, then such law favours private parties like foreign investors at the expense of other parties involved in that dispute. Conversely, if the governing law is society-oriented and concerned with the protection of social values, then the public interest embedded in such law defeat private rights and autonomy rules. The central feature of a foreign investment state contract is that it is a matter of both contract law and public regulatory law. Any kind of a foreign investment project is meant to enhance the lives of people of a host state by stimulating economic growth. It greatly affects the interests of people, especially those of developing nations as they own natural wealth and other resources of their country. For the choice of law rule, to return to Brainerd Currie, "*is an odd creature among laws, it never tells what the result would be"*. The interests of people of developing states involved in the implementation of foreign investment projects should not be determined by such a blind fate.

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A P P E N D I X I

TREATY BETWEEN THE UNITED STATES OF AMERICA AND MONGOLIA CONCERNING THE ENCOURAGEMENT AND RECIPROCAL PROTECTION OF INVESTMENT

The United States of America and Mongolia (hereinafter the "Parties");

Desiring to promote greater economic cooperation between them, with respect to investment by nationals and companies of one Party in the territory of the other Party;

Recognizing that agreement upon the treatment to be accorded in such investment will stimulate the flow of private capital and the economic development of the Parties;

Agreeing that fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources;

Recognizing that the development of economic and business ties can contribute to the well-being of workers in both Parties and promote respect for internationally recognized worker rights; and

Having resolved to conclude a Treaty concerning the encouragement and reciprocal protection of investment;

Have agreed as follows:

ARTICLE I

1. For the purposes of this Treaty,

(a) "investment" means every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt, and service and investment contracts; and includes:

(i) tangible and intangible property, including rights, such as mortgages, liens and pledges;

(ii) a company or shares of stock or other interests in a company or interests in the assets thereof;

(iii) a claim to money or a claim to performance having economic value, and associated with an investment;

(iv) intellectual property which includes, inter alia, rights relating to:

literary and artistic works,

including sound recordings,

inventions in all fields of human

endeavor,

industrial designs,

semiconductor mask works,

trade secrets, know-how, and

confidential business information, and

trademarks, service marks, and trade

names; and

(v) any right conferred by law or contract, and any licenses and permits pursuant to law;

(b) "company" of a Party means any kind of corporation, company, association, partnership, or other organization, legally constituted under the laws and regulations of a Party or a political subdivision thereof whether or not organized for pecuniary gain, or privately or governmentally owned or controlled;

(c) "national" of a Party means a natural person who is national of a Party under its applicable law;

(d) "return" means an amount derived from or associated with an investment, including profit; dividend; interest; capital gain; royalty payment; management, technical assistance or other fee; or returns in kind;

(e) "associated activities" include the organization, control, operation, maintenance and disposition of companies, branches, agencies, offices, factories or other facilities for the conduct of business; the making, performance and enforcement of contracts; the acquisition, use, protection and disposition of property of all kinds including intellectual property rights; the borrowing of funds; the purchase, issuance, and sale of equity shares and other securities; and the purchase of foreign exchange for imports;

(f) "investment authorization" means an authorization granted by the foreign investment authority of a Party to an investment or a national or company of the other Party;

(g) "investment agreement" means a written agreement between the national authorities of a Party and an investment or a national or company of the other Party that (i) grants rights with respect to natural resources or other assets controlled by the national authorities and (ii) the investment, national or company relies upon in establishing or acquiring an investment.

2. Each Party reserves the right to deny to any company the advantages of this Treaty if nationals of any third country control such company and, in the case of a company of the other Party, that company has no substantial business activities in the territory of the other Party or is controlled by nationals of a third country with which the denying Party does not maintain normal economic relations.

3. Any alteration of the form in which assets are invested or reinvested shall not affect their character as investment.

ARTICLE II

1. Each Party shall permit and treat investment, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third country, whichever is the most favorable, subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Annex to this Treaty. Each Party agrees to notify the other Party before or on the date of entry into force of this Treaty of all such laws and regulations of which it is aware concerning the sectors or matters listed in the Annex. Moreover, each Party agrees to notify the other of any future exception with respect to the sectors or matters listed in the Annex, and to limit such exceptions to a minimum. Any future

exception by either Party shall not apply to investment existing in that sector or matter at the time the exception becomes effective. The treatment accorded pursuant to any exceptions shall, unless specified otherwise in the Annex, be not less favorable than that accorded in like situations to investments and associated activities of nationals or companies of any third country.

2. (a) Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law.

(b) Neither Party shall in any way impair by unreasonable and discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments.

(c) Each Party shall observe any obligation it may have entered into with regard to investments.

3. Subject to the laws relating to the entry and sojourn of aliens, nationals of either Party shall be permitted to enter and remain in the territory of the other Party for the purpose of establishing, developing, administering or advising company on the operation of an investment to which they, or a company of the first Party that employs them, have committed or are in the process of committing a substantial amount of capital or other resources.

4. Companies which are legally constituted under the applicable laws or regulations of one Party, and which are investments, shall be permitted to engage top managerial personnel of their choice, regardless of nationality.

5. Neither Party shall impose performance requirements as condition of establishment, expansion or maintenance of investments, which require or enforce commitments to export goods produced, or which specify that goods or services must be purchased locally, or which impose any other similar requirements.

6. Each Party shall provide effective means of asserting claims and enforcing rights with respect to investment, investment agreements, and investment authorizations.

7. Each Party shall make Public all laws, regulations, administrative practices and procedures, and adjudicatory decisions that pertain to or affect investments.

8. The treatment accorded by the United States of America to investments and associated activities of nationals and companies of Mongolia under the provisions of this Article shall in any State, Territory or possession of the United States of America be no less favorable than the treatment accorded therein to investments and associated activities of nationals of the United States of America resident in, and companies legally constituted under the laws and regulations of other States, Territories or possessions of the United States of America.

9. The most favored nation provisions of this Article shall not apply to advantages accorded by either to nationals or companies of any third country by virtue of:

(a) that Party's binding obligations that derive from full membership in a free trade area or customs union; or

(b) that Party's binding obligations under any multilateral international agreement under the framework of the General Agreement on Tariffs and Trade that enters into force subsequent to the signature of this Treaty.

1. Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization ("expropriation") except: for a public purpose; in a nondiscriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of treatment provided for in Article II(2). Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriatory action was taken or became known, whichever is earlier; be calculated on the basis of the prevailing market rate of exchange at that time; be paid without delay; include interest at a commercially reasonable rate from the date of expropriation; be fully realizable; and be freely transferable.

2. A national or company of either Party that asserts that all or part of its investment has been expropriated shall have a right to prompt review by the appropriate judicial or administrative authorities of the other Party to determine whether any such expropriation has occurred and, if so, whether such expropriation, and any associated compensation, conforms , to the principles of international law.

3. Nationals or companies of either Party whose investments suffer losses in the territory of the other Party owing to war or other armed conflict, revolution, state of national emergency, insurrection, civil disturbance or other similar events shall be accorded treatment by such other Party no less favorable than that accorded to its own nationals or companies or to nationals or companies of any third country, whichever is the most favorable treatment, as regards any measures it adopts in relation to such losses.

ARTICLE IV

1. Each Party shall permit all transfers related to an investment to be made freely and without delay into and out of its territory. Such transfers include: (a) returns; (b) compensation pursuant to Article III; (c) payments arising out of an investment dispute; (d) payments made under a contract, including amortization of principal and accrued interest payments made pursuant to a loan agreement; (e) proceeds from the sale or liquidation of all or any part of an investment; and (f) additional contributions to capital for the maintenance or development of an investment.

2. Transfers shall be made in a freely usable currency, as defined in Article 30 of the Articles of Agreement of the International Monetary Fund, at the prevailing market rate of exchange on the date of transfer with respect to spot transactions in the currency to be transferred.

3. Notwithstanding the provisions of paragraphs 1 and 2, either Party may maintain laws and regulations (a) requiring reports of currency transfer; and (b) imposing income taxes by such means as a withholding tax applicable to dividends or other transfers. Furthermore, either Party may protect the rights of creditors, or ensure the satisfaction of judgments in adjudicatory proceedings, through the equitable, nondiscriminatory and good faith application of its law.

4. Each Party shall permit returns in kind to be made as authorized or specified in an investment authorization, investment agreement, or other written agreement between the Party and an investment or a national or company of the other Party.

ARTICLE V

The Parties agree to consult promptly, on the request of either, to resolve any disputes in connection with the Treaty, or to discuss any matter relating to the interpretation or application of the Treaty.

ARTICLE VI

1. For purposes of this Article, an investment dispute is a dispute between a Party and a national or company of the other Party arising out of or relating to (a) an investment agreement between that Party and such national or company; (b) an investment authorization granted by that Party's foreign investment authority to such national or company; or (c) an alleged breach of any right conferred or created by this Treaty with respect to an investment.

2. In the event of an investment dispute, the parties to the dispute should initially seek a resolution through consultation and negotiation. If the dispute cannot be settled amicably, the national or company concerned may choose to submit the dispute for resolution:

(a) to the courts or administrative tribunals of the Party that is party to the dispute;

(b) in accordance with any applicable, previously agreed dispute-settlement procedures; or

(c) in accordance with the terms of paragraph 3.

3. (a) Provided that the national or company concerned has not submitted the dispute for resolution under paragraph 2 (a) or (b) and that six months have elapsed from the date on which the dispute arose, the national or company concerned may choose to consent in writing to the submission of the dispute for settlement by binding arbitration:

(i) to the International Centre for the Settlement of Investment Disputes ("Centre") established by the convention on the Settlement of Investment Disputes between States and Nationals of Other States, done at Washington, March 18, 1965 ("ICSID Convention"), provided that the Party is a party to such Convention; or

(ii) to the Additional Facility of the Centre, if the Centre is not available; or

(iii) in accordance with the Arbitration Rules of the United Nations Commission on International Trade Law (UNICTRAL); or

(iv) to any other arbitration institution rules, or in accordance with any other arbitration rules, as may be mutually agreed between the parties to the dispute.

(b) Once the national or company concerned has so consented, either party to the dispute may initiate arbitration in accordance with the choice so specified in the consent.

4. Each Party hereby consents to the submission of any investment dispute for settlement by binding arbitration in accordance with the choice specified in the written consent of the national or company under paragraph 3. Such consent, together with the written consent of the national or company when given under paragraph 3 shall satisfy the requirement for:

(a) written consent of the parties to the dispute for purposes of Chapter II of the ICSID Convention (Jurisdiction of the Centre) and for purposes of the Additional Facility Rules; and

(b) an "agreement in writing" for purposes of Article II of the United Nations Convention on the Recognition and enforcement of Foreign Arbitral Awards, done at New York, June 10, 1958 ("New York Convention").

5. Any arbitration under paragraph 3(a) (ii), (iii) or (iv) of this Article shall be held in a state that is a party to the New York Convention.

6. Any arbitral award rendered pursuant to this Article shall be final and binding on the parties to the dispute. Each Party undertakes to carry out without delay the provisions of any such award and to provide in its territory for its enforcement.

7. In any proceeding involving an investment dispute, a Party shall not assert, as a defense, counterclaim, right of set-off or otherwise, that the national or company concerned has received or will receive, pursuant to an insurance or guarantee contract, indemnification or other compensation for all or part of its alleged damages

8. For purposes of an arbitration held under paragraph 3 of this Article, any company legally constituted under the applicable laws and regulations of a Party or a political subdivision thereof but that, immediately before the occurrence of the event or events giving rise to the dispute, was an investment of nationals or companies of the other Party, shall be treated as a national or company of such other Party in accordance with Article 25 (2) (b) of the ICSID Convention.

ARTICLE VII

1. Any dispute between the Parties concerning the interpretation or application of the Treaty which is not resolved through consultations or other diplomatic channels, shall be submitted, upon the request of either Party, to an arbitral tribunal for binding decision in accordance with the applicable rules of international law. In the absence of an agreement by the Parties to the contrary, the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL), except to the extent modified by the Parties or by the arbitrators, shall govern.

2. Within two months of receipt of a request, each Party shall appoint an arbitrator. The two arbitrators shall select a third arbitrator as Chairman, who is a national of a third State. The UNCITRAL Rules for appointing members of three member panels shall apply mutatis mutandis to the appointment of the arbitral panel except that the appointing authority referenced in those rules shall be the Secretary General of the Centre.

3. Unless otherwise agreed, all submissions shall be made and all hearings shall be completed within six months of the date of selection of the third arbitrator, and the Tribunal shall render its decisions within two months of the date of the final submissions or the date of the closing of the hearings, whichever is later.

4. Expenses incurred by the Chairman, the other arbitrators, and other costs of the proceedings shall be paid for equally by the Parties. The Tribunal may, however, at its discretion, direct that a higher proportion of the costs be paid by one of the Parties.

ARTICLE VIII

The provisions of Article VI and VII shall not apply to a dispute arising (a) under the export credit, guarantee or insurance programs of the Export-Import Bank of the United States or (b) under other official credit, guarantee or insurance arrangements pursuant to which the Parties have agreed to other means of settling disputes.

ARTICLE IX

This Treaty shall not derogate from:

(a) laws and regulations, administrative practices or procedures, or administrative or adjudicatory decisions of either Party;

(b) international legal obligations; or

(c) obligations assumed by either Party, including those contained in an investment agreement or an investment authorization, that entitle investments or associated activities to treatment more favorable than that accorded by this Treaty in like situations.

ARTICLE X

1. This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

2. This Treaty shall not preclude either Party from prescribing special formalities in connection with the establishment of investments, but such formalities shall not impair the substance of any of the rights set forth in this Treaty.

ARTICLE XI

1. With respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party.

2. Nevertheless, the provisions of this Treaty, and in particular Article VI and VII, shall apply to matters of taxation only with respect to the following:

(a) expropriation, pursuant to Article III;

(b)transfers, pursuant to Article IV; or

(c)the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VI (1) (a) or (b),

to the extent they are not subject to the dispute settlement provisions of a Convention for the avoidance of double taxation between the two Parties, or have been raised under such settlement provisions and are not resolved within a reasonable period of time.

ARTICLE XII

This Treaty shall apply to the political subdivisions of the Parties.

ARTICLE XIII

1. This Treaty shall enter into force thirty days after the date of exchange of instruments of ratification. It shall remain in force for a period of ten years and shall continue in force unless terminated in accordance with paragraph 2 of this Article. It shall apply to investments existing at the time of entry into force as well as to investments made or acquired thereafter.

2. Either Party may, by giving one year's written notice to the other Party, terminate this Treaty at the end of the initial ten year period or at any time thereafter.

3. With respect to investments made or acquired prior to the date of termination of this Treaty and to which this Treaty otherwise applies, the provisions of all of the other Articles of this Treaty shall thereafter continue to be effective for a further period of ten years from such date of termination.

4. The Annex and Protocol shall form an integral part of the Treaty.

IN WITNESS WHEREOF, the respective plenipotentiaries have signed this Treaty.

DONE in duplicate at Washington on the sixth of October, 1994, in the English and Mongolian languages, both texts being equally authentic.

FOR THE UNITED STATES OF AMERICA: [signature]

FOR MONGOLIA: [signature]

ANNEX

1. The United States reserves the right to make or maintain limited exceptions to national treatment, as provided in Article II, paragraph 1, in the sectors or matters it has indicated below:

air transportation; ocean and coastal shipping; banking, insurance, securities and other financial services; government grants; government insurance and loan programs; energy and power production; customhouse brokers; ownership of real property; ownership and operation of broadcast or common carrier radio and television stations; ownership of shares in the Communications Satellite Corporation; the provision of common carrier telephone and telegraph services; the provision of submarine cable services; use of land and natural resources; mining on the public domain; and maritime services and maritime-related services.

2. The United States reserves the right to make or maintain limited exceptions to most favored nation treatment, as provided in Article II, paragraph 1, in the sectors or matters it has indicated below:

ownership of real property; mining on the public domain; maritime services and maritime-related services; and primary dealership in United States government securities.

3. Mongolia reserves the right to make or maintain limited exceptions to national treatment, as provided in Article II, paragraph 1, in the sectors or matters it has indicated below:

land ownership and banking

PROTOCOL

With respect to Article 11, paragraph 1, the Parties confirm their mutual understanding that the national and most favored nation treatment obligations specified therein apply to the establishment and acquisition as well as to the expansion, management, conduct, operation and sale or other disposition of investments.

A P P E N D I X I I

1803 (XVII) RESOLUTION ON PERMANENT SOVEREIGNTY OVER NATURAL RESOURCES

The General Assembly,

Recalling its resolutions 523 (VI) of 12 January 1952 and 626 (VII) of 21 December 1952,

Bearing in mind its resolution 1314 (XIII) of 12 December 1958, by which it established the Commission on Permanent Sovereignty over Natural Resources and instructed it to conduct a full survey of the status of permanent sovereignty over natural wealth and resources as a basic constituent of the right to self-determination, with recommendations, where necessary, for its strengthening, and decided further that, in the conduct of the full survey of the status of the permanent sovereignty of peoples and nations over their natural wealth and resources, due regard should be paid to the rights and duties of States under international law and to the importance of encouraging international co-operation in the economic development of developing countries,

Bearing in mind its resolution 1.515 (XV) of 15 December 1960, in which it recommended that the sovereign right of every State to dispose of its wealth and its natural resources should be respected,

Considering that any measure in this respect must be based on the recognition of the inalienable right of all States freely to dispose of their natural wealth and resources in accordance with their national interests, and on respect for the economic independence of States,

Considering that nothing in paragraph 4 below in any way prejudices the position of any Member State on any aspect of the question of the rights and obligations of successor States and Governments in respect of property acquired before the accession to complete sovereignty of countries formerly under colonial rule,

Noting that the subject of succession of States and Governments is being examined as a matter of priority by the International Law Commission,

Considering that it is desirable to promote international co-operation for the economic development of developing countries, and that economic and financial agreements between the developed and the developing countries must be based on the principles of equality and of the right of peoples and nations to self-determination,

Considering that the provision of economic and technical assistance, loans and increased foreign investment must not be subject to conditions which conflict with the interests of the recipient State,

Considering the benefits to be derived from exchanges of technical and scientific information likely to promote the development and use of such resources and wealth, and the important part which the United Nations and other international organizations are called upon to play in that connexion,

Attaching particular importance to the question of promoting the economic development of developing countries and securing their economic independence,

Noting that the creation and strengthening of the inalienable sovereignty of States over their natural wealth and resources reinforces their economic independence,

Desiring that there should be further consideration by the United Nations of the subject of permanent sovereignty over natural resources in the spirit of international co-operation in the field of economic development, particularly that of the developing countries,

I

Declares that:

1. The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the wellbeing of the people of tile State concerned.

2. The exploration, development and disposition of such resources, as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities,

3. In cases Ii-here authorization is granted, the capital imported and the earnings on that capital shall be governed by the terms thereof, by the national legislation in force, and by international law. The profits derived must be shared in the proportions freely agreed upon, in each case, between the investors and the recipient State, due care being taken to ensure that there is no impairment, for any reason, of that State's sovereignty over its natural wealth and resources.

4. Nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law. In any case where the question of compensation gives rise to a controversy, the national jurisdiction of the State taking such measures shall be exhausted. However, upon agreement by sovereign Statesand other parties concerned, settlement of the dispute should be made through arbitration or international adjudication.

5. The free and beneficial exercise of the sovereignty of peoples and nations over their natural resources must be furthered by the mutual respect of States based on their sovereign equality.

6. International co-operation for the economic development of developing countries, whether in the form of public or private capital investments, exchange of goods and services, technical assistance, or exchange of scientific information, shall be such as to further their independent national development and shall he based upon respect for their sovereignty over their natural wealth and resources.

7. Violation of the rights of peoples and nations to sovereignty over their natural wealth and resources is contrary to the spirit and principles of the Charter of the United Nations and hinders the development of international cooperation and the maintenance of peace.

8. Foreign investment agreements freely entered into by or between sovereign States shall be observed in good faith; States and international organizations shall strictly and conscientiously respect the sovereignty of peoples and nations over their natural wealth and resources in accordance with the Charter and the principles set forth in the present resolution.

II

Welcomes the decision of the International Law Commission to speed up its work on the codification of the topic of responsibility of States for the consideration of the General Assembly;[1]

III

Requests the Secretary-General to continue the study of the various aspects of permanent sovereignty over natural resources, taking into account the desire of Member States to ensure the protection of their sovereign rights while encouraging international co-operation in the field of economic development, and to report to the Economic and Social Council and to the General Assembly, if possible at its eighteenth session.

1194th plenary meeting,

14 December 1962.

[1] Official Records of the General Assembly, Seventeenth Session, Supplement No. 9 (A/5209), paras 67-69.